

**Association of Private Airport Operators  
(APAO)**

Responding to AERA Consultation paper on  
Regulatory Philosophy and Approach in  
Economic Regulation of Airports and Air  
Navigation Services

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## 1 Overall View on Philosophies and Approaches taken in Paper

- 1.1 Association of Private Airport Operators (APAO) welcomes the approach taken by AERA (“Authority”) in devising this consultation paper, providing opportunities for the stakeholders to respond to the AERA’s proposed approach in tariff determination. APAO notes that the objectives for the regulator have been well-defined in the paper and indicates the required clarity of thought that is needed in order to regulate this growing sector.
- 1.2 APAO welcomes the stand of the Authority in clause 3.6 a) that it would seek to facilitate “wider policy aims for the aviation sector through the regulation of major airports, recognising their role in the sector and economy”. This statement links back to the policy aims to address the needs of the civil aviation industry. The above objective is further buttressed by AERA’s objective in clause 3.6 c) to “promote investment in airports and air navigation services and their effective management so that all reasonable demands for airport services are met efficiently.”
- 1.3 However, some of the approaches indicated by the Authority are not fully aligned with these well-articulated objectives. Some of the concerns that APAO has in this regard are as follows:
  - 1.3.1 APAO believes that the Central Government’s intentions and objectives at the time of airport privatization as evident in the Policy on Airport Infrastructure, the approach followed to privatization and the concession agreements were critical determinants in the private airport operators’ decision making framework. AERA would have a large role to play in ensuring that these objectives and intentions are realized in the manner in which they were spelt out by the Central Government.
  - 1.3.2 Authority’s mandate requires it to take into consideration the concessions offered by the Central Government in any agreement in its decision making. The same needs to be committed explicitly in terms of honouring the sanctity of these existing contracts. Past Instances from other infrastructure sectors in India like Power Sector have shown that any violation of contractual sanctity creates a large negative impact on investors’ perception and severely damages the long-term investment potential in the sector.
  - 1.3.3 The Authority has stated that it would consider the effect of the concession agreement in its decision-making process, but it is not clear as to how Authority would enforce these provisions and address the investors’ perception of the regulatory risks.
  - 1.3.4 The Authority has indicated that it would consider increased cost of capital to address the risks caused by various regulatory positions, APAO considers this as sub-optimal. From the perspective of the users, it is better for the airport regulator to minimize the risks of investment for the airport operator to the extent possible, instead of seeking to address them as increased costs. For example, a complete *grandfathering of concession agreements* and conventional assumptions at the time of bidding, providing greater certainty on future capital investments, truing up for demand risks etc. would result in mitigated risks for the airport operators, who may then in the interest of air passengers, be required to pass these benefits on to the users through reduced cost of capital.

- 1.3.5 The Authority has offered to consider the concession agreements only in the first tariff review period, without providing any certainty for the future regulatory reviews. APAO's understanding is that the same shall be continued in the future review periods but the fact needs to be clearly stated so as to conform to the stated operating principle of the Authority as per clause 3.8 c) to bring "*consistency and predictability in regulatory policy*". APAO submits that Authority should consider all contracts and conventional understanding on aeronautical tariffs, undertaken prior to the advent of the regulator as grandfathered, without seeking to alter them in any way.
- 1.3.6 Further, APAO believes that Authority's stated objective to encourage investment in the airport sector would not be served by certain positions it has taken on User consultation, regulatory till decisions and service quality. These issues merit a more detailed assessment and discussions for achieving the stated objectives.
- 1.3.7 The investment risks of the operators would be increased if the Authority were to proceed with its proposed approach on the following:
  - i) Unrealistic consultation expectations and lack of steps to address the airport operator's concerns on gaming from strong user groups
  - ii) Non-aeronautical revenue potential needs to be assessed in a realistic manner
  - iii) Stringent service quality parameters over and above what is likely to be materially desirable by the airport users. Linkages between service quality and capex and opex for the airport operator need more detailed and specific discussions.
  - iv) Lack of adequate consideration to the likely impact
- 1.3.8 While seeking to enforce cost-reflectivity of airport charges, the Authority can take certain steps that result in optimization of airport charges. For example,
  - i) Appropriate improvements in air navigation service would assist the airports in improving their efficiencies and making them more cost effective
  - ii) The various cross-subsidization elements inbuilt in the current regime would serve to distort the cost-reflectiveness principles.
- 1.3.9 While the Authority has discussed materiality of charges in the cargo and ground handling sections, it should also consider the impact of the airport charges on airlines. It has been estimated that the airport charges form a low proportion of the airlines' operating expenditure, while they are the bread and butter for the airport operators.
- 1.4 In order to achieve complete cost-reflectivity in the airport sector, it is important that the Authority takes a comprehensive view of the structural changes that have happened – unbundling of Air Navigation Services, Privatization of airport operations etc. Authority could set an additional objective that it would seek to bring in greater transparency in accounting and to facilitate a long term aim to ensure cost-reflectivity in the entire sector.
- 1.5 Authority has omitted to discuss the need for greater consumer education in enforcing the discipline among air passengers and airport users to pay for quality of

service. Airports have faced problems in enforcing even legitimately allowed charges as per concession agreements leading to large revenue leakages. Further, Authority may take into consideration the fact that payments from airlines get delayed while determining tariff.

- 1.6 Central Government estimates<sup>1</sup> a requirement of \$30 billion in airport infrastructure investments to cater to strong growth in airport traffic - domestic traffic alone could grow to 160 million - 180 million operations a year by 2020. Given that other infrastructure sectors in India also have strong growth plans, private sector funds would have options to flow into those sectors that provide reasonable return assurances through the provision of a stable and transparent regime.
- 1.7 We discuss some of the major concerns with the consultation paper in the following sections

## **2 Existing Concession Agreements**

- 2.1 As indicated in Clause 3.4 (Part – 1) of the consultation paper, Authority is required to take into consideration among other things, “the concession offered by the Central Government in any agreement or memorandum of understanding or otherwise” in its decisions for aeronautical tariffs at major airports.
- 2.2 In Clauses 2.10, 2.34, 2.35, 4.26 and 8.17 (Part – 2), the Authority has responded to concerns from stakeholders regarding the impact of revenue share payments, indication of till definitions, regulatory asset base and the necessity for respecting sanctity of contracts. It has indicated that it will “consider the effect of any concession agreement on its approach for affected airports before determining tariffs for the first tariff cycle”.
- 2.3 *APAO believes that the above commitment is unsatisfactory and does not adequately address the concerns of the airport operators. It is not clear as to how the Authority would ensure that provisions of concession agreement are honoured beyond the first tariff cycle and investor perception of regulatory risk would be addressed.*
- 2.4 There are very serious risks inherent in the treatment of concession agreement provisions in the consultation paper, and Authority must explicitly recognise and seek to address the following:
  - 2.4.1 The fact that capital-intensive airport projects were expected to be bid in the absence of a regulatory authority and without adequate clarity on the level of tariffs to be followed for a key revenue component, by itself was a huge investment risk. For example, the impact of a 100% single till in revenue share for DIAL and MIAL, and on the level of UDF sought for BIAL and GHIAL is extremely high, and such an assumption at the bid stage would have resulted in a complete revision of commercial assumptions, bid parameters, revenue models, project phasing. This would go against the very first principle that Authority has set for itself in Clause 3.6 of part – 1, which is

*“Facilitating wider policy aims for the aviation sector through the regulation of major airports, recognising their role in the sector and economy”*

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<sup>1</sup> Central Government’s estimates based on a recent statement by Mr. M. Madhavan Nambiar, Civil Aviation Secretary, GoI during the US-India Aviation Partnership Summit in Washington, 8 December, 2009

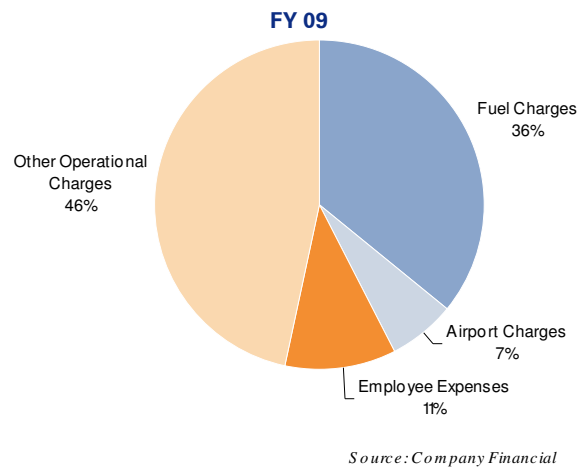
- 2.4.2 In several iterations, private airports with concession agreements have shared the revenue assumptions and the financial models with the Government – subsequent to the bid process, financial closure and at the tariff approval stage, and the Government has taken cognizance of the input parameters. APAO would like to draw attention to Clause 3.47 of the consultation paper, where the Authority has judged that the cost of debt be taken at actuals, since *“significant investments have already taken place with significant amounts of debt financing already secured.”*
- 2.4.3 The same argument may be extended to all assumptions that have gone into the model used to secure financial closure, not merely the ones regarding the cost of financing. For example, tariff assumptions were not merely random assumptions, but were based on a judicious interpretation of the concession agreement provisions. Lenders to the project have committed their investment based on these assumptions, which would need to be respected by the Authority.
- 2.5 The issue of sanctity of contracts is a larger issue, whose implications would be felt much beyond Authority’s limited mandate on aeronautical tariff fixation. One of the key criteria of opening up the aviation sector was involvement of foreign players in the aviation sector and one of the biggest concerns of international investors in developing countries is the extent to which contracts are seen to be enforceable. Any ambiguity would only lead to perception of increased regulatory risk for these potential participants and could adversely impact future investments. While Authority has clarified its stance for the future of airport regulation, it should explicitly safeguard the existing concession agreements, both in letter and in spirit.

In the Power sector, there are case studies on the issue of contracts (Power Purchase Agreements) which have been executed before the setting up of the Regulatory commissions and prior to the commencement of the regulations. The issue has been looked into in great detail by the Commissions and the Appellate Tribunal of Electricity (APTEL), which has deliberated on the status of such agreements and also to decide on the matter whether the Commission has the power to look into agreements entered into and concluded prior to its setting up as the Act or the Regulations. The various judgements on the issue clearly indicate that the legislation does not provide for the same and a retrospective use of the power may result in vested rights being affected.

2.6 Therefore, it is important for Authority to commit explicitly that for the four airports with concession agreements, the contracts are to be considered as grandfathered, and the tariff process be followed in accordance with the agreement for the entire period and not merely during the first tariff cycle. Further, where the contractual process leaves room for interpretation and ambiguities, reasonable assumptions undertaken by the bidders and shared with the Government at various stages should also be treated as inviolable. This includes for example, the definition of till in their financial models. A change of till approach would mean that the entire presumption on which the projects were financed is under question, and would severely impact the continued bankability of these projects.

### 3 Airport costs and benefits to airlines

3.1 Aeronautical charges at the airports are one of the less significant components of an airline’s expenditure. The following graph shows the combined cost break-up for Jet Airways and Kingfisher airlines. The airport charges (landing, housing, parking and air navigation) form 7% of the total charges. Of these, a significant portion (more than 50%) is estimated to be on account of Route Navigation and Terminal Navigation (RNFC and TNLC) charges<sup>2</sup> Therefore, the charges attributable directly to airports are around – 4% of the cost structure of an airline.



3.2 The five private airports (DIAL, MIAL, BIAL, GHIAL and CIAL) account for more than 64% of country’s air traffic. If we assume that the traffic routes of the two major airlines closely mirror the traffic situation in India, it can be shown that they cater to around 3.1 - 3.3 million departing passengers each from these airports. As inferred from the financials of Kingfisher airlines, the incidence of airport charges including navigation fees is around Rs. 340 per passenger. Since navigation charges are estimated to form more than 50% of the airline’s expenses, the landing housing and parking charges per passenger works out to less than Rs. 170 per passenger. Against

<sup>2</sup> Reference: AAI Annual Report

this, the impact of 50% change in airport charges on airlines at all five airports would be equivalent to around 0.8% change in the fuel charges of these airlines. Oil marketing companies have frequently decreased and increased fuel prices to this magnitude, responding to market forces.

- 3.3 This indicative analysis only seeks to establish the significant difference that exists between the materiality of airport charges for airlines and airports. Aeronautical revenues form the bread and butter of airports, and a justified return on investment is necessary for continued provision of good quality of service to airlines as well as to air passengers. However, the same cannot be said of airlines where the impact of congestion and drop in service levels is much more significant than changes in airport charges.
- 3.4 *While adopting a framework for regulation, Authority should look at the larger context and implications for the aviation sector as a whole. In the effort to seek balance, any tilt away from airport investors has a far greater impact on economic outcomes for the sector than any benefit for users in the form of reduced prices. This is a very important factor that Authority may like to consider at this important juncture in India's aviation sector.*



## 4 Regulatory Till Approach

4.1 Authority while taking a position on the till approach acknowledges that arguments for dual till are “not trivial”. However, for India it considers single till to be the most appropriate regime because

- Non-aero revenues are deemed to be a function of aero revenues
- Single till ensures service quality commensurate with charges
- Single till avoids the complications of cost allocations between aero and non-aero buckets

4.1.1 APAO would like to submit that in clause 2.24, it is argued that the demand persistently exceeding a constrained level of capacity does not appear to be relevant for the Indian case. However, in light of the fact that air traffic has consistently beaten demand estimates, the Authority may need to revisit this argument.

Passenger Traffic (In Million)	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09 (Apr - Oct)	2008-09 (extrapolated)
Domestic Passenger Traffic	28.9	32.1	39.9	51.0	70.6	87.1	45.6	91.14
International Passenger Traffic	14.8	16.6	19.4	22.4	25.8	29.8	17.8	35.64
<b>Total Passenger Traffic</b>	<b>43.7</b>	<b>48.8</b>	<b>59.3</b>	<b>73.3</b>	<b>96.4</b>	<b>116.9</b>	<b>63.4</b>	<b>126.8</b>

*Source: AAI Data, Ministry of Civil Aviation, Annual Report 2008-09*

- 4.1.2 In clause 2.43, the Authority has stated that a Single Till approach protects interests of users by ensuring service provision commensurate with the respective tariff / charges. The argument does not seem to follow from the explanations provided in the preceding paragraphs. The basis for Single Till being the most appropriate basis needs to be established conclusively. For example, the regulator in France has proposed a shift to dual till for Paris airport (Refer Annexure 1)
- 4.1.3 Also, London's Heathrow Airport - a well known airport following single till approach has been listed under IATA's Hall of Shame on account of high charges and poor service quality.
- 4.1.4 In clause 2.43, the Authority has stated that a Single till approach takes all airport assets and costs into account thus avoiding complications relating to cost allocations etc. inherent under a dual till approach. *APAO would like to submit that internationally such cost allocation methodologies are available and documented in various regimes and the same can be adapted in Indian context. This should not be the basis for rejecting the dual till approach.*
- 4.2 The dual till approach should be examined as single till approach has certain perceived shortcomings:
- 4.2.1 Single till is ineffective for congested airports and there is no benefit to end users i.e. passengers.
- 4.2.2 It is an established fact that single till may lead to Averch-Johnson Effect<sup>7</sup>. Whenever the allowed rate of return is greater than the opportunity cost of capital, airports have an incentive to expand their capital base. In this case airports will choose more technologies that are capital intensive and less intensive in labour than would be socially efficient – the so called Averch-Johnson effect. If aeronautical services are more capital intensive than non-aeronautical services then, so as to secure this effect, airports will want to expand output of the former relative to the latter resulting in capital inefficiencies.
- 4.2.3 Single till does not incentivize development of Non-Aero revenue. Hence, assumption that Single till will bring charges lower may not be correct. For instance, some of the world's most expensive airports have single till.
- 4.2.4 The current international regulatory approach suggests merits in the dual till approach as evident in some of the airports moving from single till to dual till regime.
- i) At Brussels Airport, the movement from single to dual till is taking place.
  - ii) At Aero ports de Paris, recent proposals envisage taking retail activities out of regulation from 2011, with the possibility remaining of transferring other activities over time. Paris Airport on a single till is more expensive than near neighbour European hub Amsterdam (dual till) or Copenhagen and Brussels (hybrid).
  - iii) The United States provides a useful comparable environment in which residual cost (single till) airports operate alongside compensatory (dual till)

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<sup>7</sup> H. Averch and L. Johnson. "The Behaviour of the Firm under Regulatory Constraint", American Economic Review, Dec, 1962

and hybrids). Currently only about one-third of agreements at major US airports are on a residual basis, compared to almost 60% in 1983.

- 4.3 APAO would like to reiterate that the Authority should examine the merits of arguments in favor of dual till approach. There are adequate international examples of dual till airports and comparable benchmarks with single till airports could be established to evaluate the benefits of respective approaches.
- 4.4 In the international context, while a cursory look at the till regimes would show most of the airports having adopted single till, a closer scrutiny of airports with context similar to India i.e. Private Airport Operators owning majority equity stake in the airports reveals that other than UK all countries have adopted a dual till regime.
- 4.5 *APAO would also like to submit that from a long term for the growth of Indian airport sector and to encourage investments (one of the stated objectives of Authority), an enabling environment should be created through the regulatory framework. The regulations should address the concerns of potential investors and also convey right signals to them on the long term viability and stability of sector. APAO strongly feels that adoption of dual till would be right step in this regard.*

#### **4.6 Treatment of Cargo/ Ground handling and Fuel farms concessions**

On the treatment of Cargo/ Ground handling services APAO would like to state the following points:

- 4.6.1 Airport Operators have followed a competitive process for selection of concessionaires for these services
- 4.6.2 As per OMDA, Cargo Handling and Ground Handling services are specifically included as non aeronautical services. Fuel concession is neither included in aeronautical nor in non aeronautical services. However, as per ICAO guidelines, concession granted to Oil Companies to supply aviation fuel falls under revenue from non aeronautical sources
- 4.6.3 While we agree that AERA may regulate these services and monitor charges to ensure that there is no monopolistic abuse. However, these charges should not form part of the Aeronautical Till.

### **5 User Consultation**

- 5.1 The Schedule 1 (Principles for Tariff Fixation) in the State Support Agreement (SSA) for Delhi & Mumbai airports states

**9. Consultation:** *The Joint Venture Company will be required to consult and have reasonable regard to the views of relevant major airport users with respect to planned major airport development.*

The User Consultation process as proposed by Authority would not apply to Delhi & Mumbai Airports as the SSA has laid down the process to be followed. These airports would need to have “reasonable regard to views of relevant major airport users”.

- 5.2 On the proposed consultation process provided in the concept paper, APAO’s views are as follows:

- 5.2.1 As provided in Clause 3.12 of Part – 1 of the consultation paper, Authority intends to have consultation mechanism between airports and users as a key principle in the regulatory process. APAO welcomes the focus provided to user consultations, and believes that soliciting the views of all stakeholders in the airport would be important in making planned investments for airport projects with long gestation periods.
- 5.2.2 However, APAO would like to submit that consultation protocol explained in Appendix 7 of the paper seems too idealistic and could lack practical considerations. In particular, the onus of conducting consultation process and seeking consensus has been completely left with the airport operator, presuming that the process itself is straightforward and apolitical, and within the ambit of the airport operators to manage. Authority has not set for itself any role in the consultation process, except for the purpose of factoring the outcomes of the consultation process in its tariff decisions. The Authority may examine the following issues in this regard
- 5.2.3 A clear definition of the objectives of a consultation process in terms of the expected results and outcomes including the elements of the plan that needs to be agreed upon and the extent of agreements that is to be sought. The consultation forum, as envisaged by Authority, is a motley mix of airlines, consumer forum and air cargo users, who may have divergent interests and may lead to lack of consensus on most investment proposals. Specifically, airport users may not uniformly benefit from any single project, and therefore there will be elements on which consensus or even simple acknowledgements may not be possible. Authority should provide a firm framework of how airports are expected to address this problem.
- 5.2.4 In APAO's views, in the Indian context, due to the prolonged exposure to under-invested airports, it is difficult to expect the users to appreciate the linkages between long-term investment projects and improvement in service quality. The present consultation approach seeks to establish the "need for investments" from airport users against "need for returns and tariff increases" from airport operators. It presumes that in case an investment is approved, users reap the benefits of quality of service and the airport operator benefits from additional tariffs. In the case that the investment is rejected, users are expected to have judged that they do not want the resultant service levels and the operator does not get the tariff increases. However, in a situation like India, the airport user may be poorly informed judging by his/her past experience in poorly managed airports, be too myopic, or engage in gaming in rejecting even legitimate investments. Therefore, APAO feels that facilitating a productive result-oriented consultation process in such an environment is bound to be an uphill task. The airport sector has a long way to go in terms of consumer education and therefore, even the consultation process should be well-managed and regulated by an informed authority, which in this case would be Authority.
- 5.2.5 Airports with concession agreements have a requirement to follow the long term Master Plan and are required to consult with the government on all major projects. Since, most of these investments have already been started such projects may not be suited for an additional level of consultation with the users. In fact, it may not be possible for the airport operator to consult on many of these projects, as these are mandatory capital expenditure items.

- 5.2.6 It is also important to consider that airports face complete risks on capital, service quality, efficiency and performance, due to continued investments. Authority has rightly identified in Exhibit 2 (Page 27 of 279) that service quality will be a determinant of both capex and opex that is used to decide tariffs. However, APAO would like to submit that Authority has not taken the necessary next steps to define how the airports are expected to conform to service quality standards, while at the same time requiring all major investments to be approved by users. In particular, the question of alignment of service quality with investments is bound to be controversial and prone to the “Tragedy of the commons”. A consultation forum will be a game of expectations between users and between users and the airports, and may not lead to optimal outcomes, if the process is stretched beyond acceptable limits. In an unequal atmosphere of risk-return trade offs, the process could allow some airport users with vested interests to derail the process, in view of their short term gains for reduced tariffs, leaving the airports to be penalized for service quality.
- 5.2.7 APAO also notes with concern that in the event of likely disagreements, Authority has not committed itself to step forward and ensure that a firm decision be taken. Clause 11 of the consultative protocol merely indicates that Authority will only maintain a “record of agreements reached” to be used in the next tariff process. In the event of disagreements, the operator is left to choose between investing and risking the same being disallowed for tariff fixation in the next review period, and withholding investments and facing service quality issues. APAO expects that the consultation process should naturally culminate in the following prior to making the investments
- i) The user groups should be made aware of the resultant benefits of the project, and the Authority should provide a final judgment on the linkage between benefits and the costs. In other words, where an investment is disagreed by users due to lack of interest, the Authority should investigate the claims of the airport operator with regards to its linkage to service quality and provide an informed opinion of the benefits. Specifically, it should absolve the operator against penalties on those elements of service quality in the future.
  - ii) The operator should be made aware of the decision on whether or not the same investment will be considered in the future tariff cycle. This will leave the operator with a clear investment rationale to invest or desist.
- 5.3 In Clause 17 iv) and vi) of Appendix 7, Authority has asked the airport operators to also share with the users, costs and details of the design requirements as well the procurement strategy of the project. Further in clause 5.20, the Authority expects to see a “full reconciliation” of the costs against that presented for tariff review. This is an extreme suggestion that is not alive to the specific context of construction risks in a developing country like India. In practice, it is almost never possible for the airport operator to forecast with accuracy the costs of construction and/or to identify a procurement strategy at early stages. It would not be fair if Authority allows the airport users to change their positions post-facto.

*“[...] Consider any material differences and communicate whether and how their positions on the project might be qualified or changed as a result of the differences.”*



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This indicates that as details of cost escalations emerge, airport users may be allowed to reverse their positions on the need for a project, and also throws open the possibility that Authority might even consider them, which needless to say, is extremely unfair to the airport operators.

- 5.4 Authority may consider limiting the consultation process to helping the airports and users to establish the need for a project and design specifications. Authority must ensure efficiency of actual investments by mandating that the airports keep a firm record of cost escalations along with detailed evidences, and options of procurement considered and may use the same to decide the RAB allowed in the next tariff process. In the absence of such a decisive framework, airports would be exposed to investment risks at every stage of construction, because of possible disagreements with airport users. Indeed, the very process of consultation and seeking agreements will delay the process and lead to further cost escalations, which would feed into a vicious cycle.
- 5.5 It has also been suggested that the traffic projections also be consulted with the airport users, and the consensus view point adopted. In practice, the perspective of different users of the airport will be completely different in estimation of traffic, and it will only add a further level of difficulty to the whole consultation approach. If the users do not agree with the base traffic estimates, no agreement on capex will be possible. As explained earlier, this increases the risks for the airport operator because in the event that the traffic projected by the operator does materialize, they would have lost the opportunity to invest in preparation for it and would have to contend with poorer service quality and the penalties associated with it. The users on the other hand, would have no penalties – except by way of diminished service benefits from the investment, which as explained above, they may have accustomed to live with by habit, rather than through an informed choice.
- 5.6 International examples point to the fact that gaming in consultation processes is a frequent problem.
- 5.6.1 In Australia for example, there is evidence that larger airlines have tried to scuttle investments favoring low cost carriers with a view to retain monopoly at the larger airports. This reinforces the need for the authority to step into the consultation process and ensure that only genuine objections with the right intentions are encouraged. Further, several projects have been delayed beyond acceptable limits, due to prolonged disagreements. For example, a terminal investment in Adelaide was delayed by as much as five years, due to protracted negotiations.
- 5.6.2 It is also conceivable that airlines would seek greater investments in airside infrastructure, while trying to suppress items of terminal infrastructure that purely benefits passengers. Examples from Australia suggests that the service quality of airports are more prone to terminal side investments which are scuttled by airlines in the consultation process. The lack of recognition of the linkage of service quality to capex leads to airport operator unfairly being penalized for the same. This is likely to be a problem in India, where consumer groups are poorly represented and heavily outnumbered by the presence of large airline lobbies.
- 5.7 Considering the above, the **following approach is suggested** for user consultation in the Indian context
- 5.7.1 **The consultation process should be facilitated by Authority for all airports.** Authority should drive the consultative process with fixed timelines and a defined time frame for end result instead of leaving it to the airports completely. It should provide an opportunity for users and the airports to place their opinions and debate the costs and benefits of the project extensively. However, in the absence of an

agreement, the Authority should provide firm directions to the operator on whether or not such an investment may be undertaken, instead of leaving the judgment uncertain to the next tariff review. There are parallels available from the regulatory process being followed in the Indian power sector. The electricity sector regulator approves the capex plans of the operators after public hearing and inviting comments from the stakeholders.

- 5.7.2 **The process of consultation should be limited to identifying the need and specifications of the project and evaluating the cost-benefit based on estimated costs and benefits, instead of trying to pre-fix execution parameters, including costs and procurement strategies.** Efficiency of investments should be judged post-facto by Authority by referring to the evidences that the airport operator has maintained with regards to costing at each stage and the processes adopted for ensuring investment efficiency.
- 5.7.3 **Special emphasis should be given to linkages to service quality, with regard to proposed, agreed and disagreed investments.** In the event that an investment proposal is rejected for any particular reason, the authority should specifically exempt the airport operator of consequent penalties on service quality, safety and non-achievement of performance standards after having judged for itself the impact of non-investment.
- 5.7.4 **For capital investments to be made by an airport operator, a thresh hold should be defined** i.e. investments falling above the thresh hold should only be subjected to the consultation process. We believe that this thresh hold limit should be 5% of gross RAB. Additionally, user consultation process should be followed only for capacity augmentation investments and investments that have been approved by the Central Government as part of the Master Plan should not be subjected to this process.
- 5.7.5 **Regarding traffic forecasting, APAO wishes to submit that a reliable and independent forecaster would be used** by the Airport Operators for forecasting aeronautical traffic across all major airports. The results would be submitted to the Regulator which would then be treated as a baseline binding item for all airport stakeholders, instead of leaving it as an item open for debate. The Authority may review the forecast annually or bi-annually after factoring in user opinions. Airports may then be allowed to use these traffic estimates and plan for investments based on ICAO principles.

## 6 Capital Investment

- 6.1 The State Support Agreement (SSA) for Delhi & Mumbai (Schedule 1) states

**8. Master Plan and Major Development Plans:** *AERA will accept the Master Plan and Major Development Plans as reviewed and commented by the GOI and will not seek to question or change the approach to development if it is consistent with these plans. However, the AERA would have the right to assess the efficiency with which capital expenditure is undertaken.*

For Delhi & Mumbai Airports, the provisions are explicit in terms of the capital investments which would be allowed as per the Master Plan. There is no scope for user consultation process for the same.



- 6.2 Section 7.2 Para 2 of the Concession Agreements for Bangalore & Hyderabad Airports states:

*... [Airport Operator] shall, taking into account and subject to increased demand, the availability of funding, the economic and profitable operation of the Airport at that time and the reasonable requirements of users of the Airport, develop and implement detailed proposals for the Expansion of the Airport...*

The intention of the above paragraph is to state that the constraints faced by the airport operator such as availability of funding and airport viability are key constituents in decision making for additional investments. The process of deliberating on additional investments cannot be left to user discussions alone.

- 6.3 On capital expenditure items, APAO also believes that the following be enshrined in the principles:

6.3.1 The capex approval cycle should be aligned with the tariff approval cycle. The position taken by Authority today leaves the five year review period untouched, and expects that a review of tariffs for truing up for capital investments happens only at the beginning of every tariff cycle. However, considering the volatile traffic, operators may be required to bring forward/ postpone their plans for investment within a review period or may need to make certain unanticipated investments on account of safety, performance parameters that were not envisaged at the time of filing. In light of the above, the regulator should allow for a de-facto review mechanism where investments above a certain threshold trigger a review of the existing regime of tariffs.

6.3.2 As indicated in the previous section, all capital investment should be treated on actual cost basis. The Authority in clause 5.37 of the Consultation paper has proposed innovative incentivisation mechanisms for out-performing capital investment estimates and time period of investment in Section 5 of the paper. In regard to this we have the following suggestions:

6.3.3 The incentive/ penalty mechanism should be applicable only on new investments - ongoing investments should not be part of it.

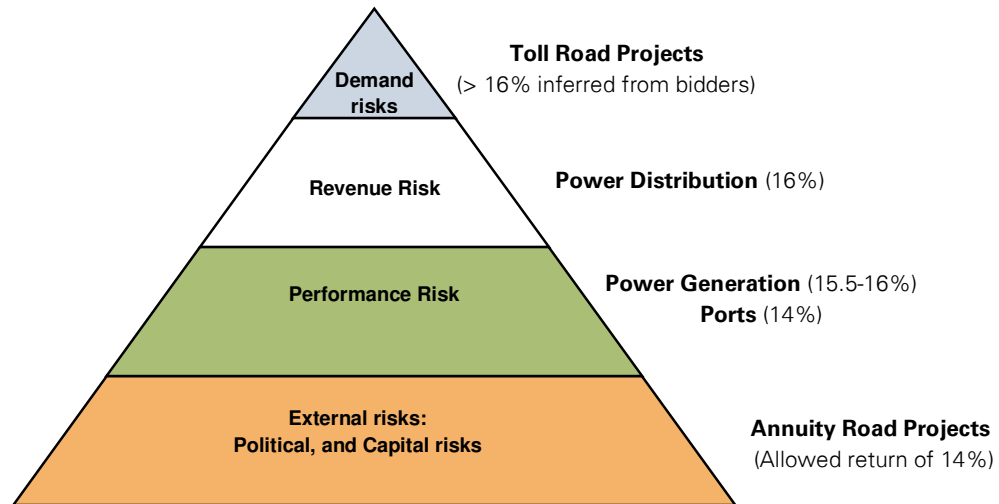
6.3.4 At the time of determining the eligibility for out performance or under performance delays due to factors beyond the operator's control must be removed from the overall timelines.

## **7 Cost of Capital**

7.1 APAO welcomes the indication by the Authority that it will consider the actual costs of debt and gearing levels in computation of cost of capital, for existing projects. This is a step that adequately recognizes the lender's risks in financing projects without regulatory clarity.

7.2 Further, APAO welcomes the depth of analysis that Authority has indicated that it will undertake in Clause 3.35. APAO agrees with the Authority's approach that a CAPM based approach would be a starting point to establish a range of cost of equity estimates, which may further be fine-tuned for Indian conditions "recognizing the differences in risk profiles" between sectors. The regulatory paper has further discussed the approaches by Indian regulators for power, ports and road sectors, in order to show case the level of cost of equity allowed in these sectors.

- 7.3 APAO has also devoted time and effort to arrive at a cost of equity that is commensurate with the risks involved in the Indian airport sector. Our approach and analysis is based on the following observations:
- 7.3.1 *Indian airports are riskier than international well known airports.* International well known airports operate under a more stable regime – traffic volatility is not very high due to matured markets, regulatory regime has been established for several years, airport operators, with several years of operational experience, have developed a strong understanding of measures required to mitigate performance risks. In contrast, Indian airport sector has witnessed a strong and volatile traffic growth, regulatory regime is nascent, airport operators are relatively new and there are certain sovereign risk factors that are especially prominent in case of airports.
- 7.4 If we were to assume a benchmark approach for asset betas at a base value of between 0.6 and 0.7 as described in Clause 50 (Page 269 of the consultation paper) as assumed by the Australian regulators, it would translate to equity beta of between 1.2 and 1.4. However, given that Indian airports are riskier than International well known airports, a better approach would be to benchmark Indian airports with other regulated infrastructure sectors in India.
- 7.5 Indian airports operate in a riskier environment compared with other regulated infrastructure sectors in India. It is useful to profile the various risk elements in these sectors (along with the imputed cost of equity in these sectors)



- 7.5.1 **External risks:** As shown in the above schematic, all three sectors face external risks (political and capital) inherent to a developing economy like India.
- 7.5.2 **Performance risks:** Power generation and ports, in addition have a large performance risk component, as the operators are severely impacted by stringent performance standards, enforced through contracts and by user agreements. Further, the actual compliance may be affected by the operator’s own ability to perform as well as by the performance of other stakeholders. Also, as airports require large pockets of land, they face risks on account of inability to implement projects or expand due to land constraints, delays/ inability to remove slums etc.
- 7.5.3 **Revenue Assurance risks:** Power distribution, in addition to external and performance risks, face a high degree of revenue assurance risk as the analysis of the financials of most power distribution companies in India would show.
- 7.5.4 **Demand risks:** Finally, toll road projects that are competitively bid out face all the above risks, in addition to being exposed to traffic risks.
- 7.6 It can be easily shown that the level of risks faced by a sector has an increased correlation with the regulated returns that the sector enjoys. For the purpose of analysis, the implied cost of equity for port sector has been back-calculated at 14% from the regulator’s guidelines for upfront tariff fixation and the implied cost of equity for toll roads has been calculated at greater than 16% from recent competitive bids. Comparing the same with the airport sector, we show that the airport sector has all the above risk elements along with others.

Risk Category	Elements
External risks – <i>Political, legal and capital</i>	<ul style="list-style-type: none"> <li>• High gestation and large capital requirements</li> <li>• Difficulties in achieving financial closure and cost escalation due to approval delays.</li> <li>• Difficulties and legal questions at the bidding stage and the difficulties in enforcing concession agreement conditions during commencement of commercial operations (Closure of existing airport, treatment of employees etc)</li> <li>• Inability to raise tariffs even to allowed levels in the absence of regulator due to political considerations</li> </ul>
Performance Risks	<ul style="list-style-type: none"> <li>• Stringent penalties in the construction and operations phase. Large component of performance evaluation is perceptible.</li> <li>• Airport performance inextricably linked to third parties – CISF, Airlines, Ground handlers, ATC etc.</li> <li>• Severe penalties for non-performance and poor service quality perceptions inherent in the contract</li> </ul>

Risk Category	Elements
Revenue Risks	<ul style="list-style-type: none"> <li>• Lack of revenue assurance due to airline defaults. Airlines including national carriers owe a large amount to the airports.</li> </ul>
Demand Risks	<ul style="list-style-type: none"> <li>• Airport sector faces one of the highest risks of traffic when compared with other sectors. While the Indian traffic has been growing considerably over the years, the impact of the downturn has also been most severe in India than elsewhere.</li> <li>• Demand risk on the non-aeronautical side is higher than the aeronautical side, as the expenditure is both susceptible to overall traffic levels and the level of discretionary spending preferences of the Indian consumer, which is poorly understood at present.</li> </ul>
Global nature of airport business	<ul style="list-style-type: none"> <li>• Airport traffic can be described as being influenced by global factors, and is thus exposed to risks on a global scale. In contrast, demand for ports in India is largely driven by national factors of commodity demand, demand for ports by regional demand and demand for roads by local factors.</li> <li>• In contrast with the above comparable sectors, airport sector is more susceptible to uncontrollable factors including global epidemics, acts of terrorism, security challenges and economic conditions.</li> </ul>
Regulatory uncertainty during bidding	<ul style="list-style-type: none"> <li>• The fact that capital-intensive airport projects were bid in the absence of a regulatory authority and without adequate clarity on the level of tariffs to be followed for a key revenue component, by itself was a huge investment risk.</li> <li>• The ambiguity in regulatory treatment between various concession agreements, and the AERA Act is a further source of risk. It can be argued that the equity risk in the airport projects have only increased since the AERA Act has been enacted, due to further uncertainties as regards to the ambit of the regulator with regards to services including cargo and Ground Handling contracts</li> </ul>
Effect of two businesses	<ul style="list-style-type: none"> <li>• Airport business is inherently a mixture of two fundamentally different businesses – infrastructure and retail services.</li> <li>• It is empirically obvious that the real estate component has a higher risk-return profile due to its high degree of volatility, which is affected by economic conditions and changing customer</li> </ul>

Risk Category	Elements
	<p>perceptions.</p> <ul style="list-style-type: none"> <li>• Therefore, the cost of equity of the two businesses will be widely divergent, and any attempt to put them under the same bucket, as with various levels of cross-subsidization using the hybrid and single till models will increase the total cost of equity to a much higher level.</li> </ul>
Country Risk Premium	<ul style="list-style-type: none"> <li>• The bids for the four private airports mandated foreign participation, and necessarily involved foreign investment.</li> <li>• As noted by the Authority, international investors would seek to be compensated for an increased country risk premium for investing in a developing country like India.</li> </ul>

- 7.7 Comparison of equity betas for risks
- 7.7.1 In terms of business risks, it is seen that regulated power generation companies like NTPC and NHPC trade at equity betas of between 0.6 and 0.8 in the Indian market.
- 7.7.2 TAMP has considered an ROCE of 16%, which has since been held for port projects.
- 7.7.3 Betas of companies engaged in power distributions including Reliance Infrastructure and Torrent Power have equity betas of well above 1.5. However, these companies also have electricity generation in their portfolio. Considering that power generation is typically of lesser risk than distribution, the beta component of power distribution will likely be above the observed equity beta. In the absence of clear benchmarks, we merely observe that it is likely that the beta of a typical power distribution company will at least 1.5. As noted by the Competition Commission in Clause 51 in Page 269 of the consultation paper, the airport sector should have equity betas of at least higher than that of power distribution.
- 7.7.4 There are no clear benchmarks for companies engaged in road projects. However, in view of the above risk profile, annuity road projects will have lower volatility of cash flows than port sector, whereas for toll projects, the volatility would be much higher.
- 7.7.5 Since power and port sector have normative gearing ratios, we assume that the gearing levels of the above companies reflect the optimal levels for their unique operational conditions. We see that the airport sector, which has a much higher risk profile, when compared with the port and road sector is likely to see an equity beta of more than 1.5. With the widely followed risk free rates and equity market premiums for Indian context, this would correspond to a minimum post tax cost of equity of at least 25%. At, say, a Debt: Equity ratio of 60:40, a post tax cost of equity of 25% and a debt rate of 11% the post tax WACC comes to at least 14.5%.
- 7.7.6 Thus, we see that for the Indian scenario, the benchmark-based approach would suggest an equity beta of around 1.3, and the risk-adjusted approach based on other sectors would suggest an equity beta of around 1.5. At, say, a Debt: Equity ratio of 60:40, a cost of equity of 25% and a debt rate of 11% the post tax WACC comes to around 14.5%.
- 7.8 The above calculation treats all airports as similar. However, we see that over and above these basic factors, several other risk factors may come into play:
- Greenfield vs Brownfield Airports – Greenfield airports have faced a larger risk of revenue assurance in closing the existing airport. Further, the increased difficulty of planning operations at a new airport vs taking over a functional airport adds to these risks
  - Geographic and Local risk factors – As noted earlier, airports in general are global businesses. However, in addition to the global risks, they also compete as hubs for catchment traffic both for passengers and cargo. Therefore, local profiles of different airports may lead to different risk premia that can be added to the generic airport risks

- Impact of regulatory variance – The impact of variance in regulatory decisions from conventional understanding is also different for different airports. For example, cash flows of DIAL and MIAL are highly volatile to even small changes in regulatory assumptions due to the presence of the large revenue share component. Similarly, in case a single till system is adopted for all airport, for BIAL and GHIAL it would fundamentally change their revenue models from 0% cross-subsidization to 100% cross-subsidization of non-aeronautical revenues which would have a large impact on their project and equity risk profiles
- All airports emerged when there was no precedence of private airports. GHIAL and BIAL as the earliest movers, also had non-standard contracts and a larger degree of uncertainty when compared with other airports

7.9 In addition to the above, there could be other airport-specific issues that add on to the risk premium of individual airports over and above generic airport risks.

*Therefore, in practice, the cost of equity of individual airports may work out higher on account of these factors%.*

APAO is aware that such cost of equity may “appear” to be excessively high for other stakeholders, though the real cost of equity is indeed high. The Authority has stated in Section 3.7 a) of Part -1 of the paper that it would try to ensure the viability of the airport operations by ensuring a fair rate of return on net investment. However, this approach is imperfect in that it does not seek to reduce the risks of investment, which would in turn reduce the fair rate of return sought. In general, the authority has within its ambit, enough powers to mitigate some of the above risks in part or in full, thereby reducing the cost of equity. Some of the key considerations could be:

- Ensuring sanctity of contracts and fundamental bid assumptions for both tariffs and service quality parameters. This will minimize perceptions of regulatory risk for future investors and investments in the airport sector.
- Ensuring separation of aeronautical and non-aeronautical revenue streams to the extent envisaged in the concession agreement and bid assumptions. This would mean dual till for BIAL and GHIAL and hybrid till for DIAL and MIAL. By separating the two businesses viz. retail and airport services, this approach will isolate the true cost of equity for airport investments which will be lower than retail businesses.
- Minimizing traffic risks through adequate truing up for aeronautical revenues.
- Minimization of risks to traffic and capital expenditure projections due to user consultation process.
- Making service quality related penalty and incentive framework objective and symmetric i.e. ratings should be linked to objective, controllable (excluding third

party agency dependent services) and measurable parameters only and there should be symmetry between incentives and penalties – the current arrangement is one-sided (this is explained in greater detail in the next section)

#### **7.10 Hypothetical RAB inclusion at market valuation**

In clause 4.26, the Authority has recognized the need for including hypothetical RAB in the regulatory base. In this regard, we would like to submit that the principle behind business valuation of assets is that an asset must be valued based on its current market potential. In case of airports, the assets transferred to the airport operators are collectively generating revenues at the prevailing tariffs and therefore have an economic value to them. In view of the above, the assets taken over from AAI must be included in the RAB at current market value.

### **8 Quality of Service**

- 8.1 The Schedule 1 (Principles for Tariff Fixation) in the State Support Agreement (SSA) for Delhi & Mumbai states

***7. Service Quality:** In undertaking its role AERA will monitor, pre-set performance in respect to service quality performance as defined in the Operations Management Development Agreement (OMDA) and revised from time to time.*

Only those service quality performance parameters provided in the OMDA be monitored by AERA.

- 8.2 Clause 9.2.2 of the Concession Agreements for Bangalore & Hyderabad Airports states:

*... shall participate in IATA surveys and shall ensure that a survey is conducted each year in accordance with IATA's requirements to determine the Airport's performance. The first such survey shall be conducted during the third (3rd) year after Airport Opening...*

Both these airports, therefore, should be monitored for the quality of parameters from the fourth year onwards as stated in the respective concession agreements.

Further Clause 9.2.6 of these concession agreements states:

*...Any liquidated damages pursuant to Article 9.2.5 above shall be paid into an Airport development fund. Monies from the Airport development fund shall be utilized to fund improvements at the Airport at the direction of the Gol...*

Any penalties therefore, would go towards the Airport Development Fund and not towards subsidizing user charges.



- 8.3 Authority has in the consultation paper detailed out elements of objective and subjective service quality parameters that it proposes to track for the sake of fixation of tariffs and penalties. APAO would like to highlight its specific concerns on the following elements:
- 8.4 APAO would like to put on record that its concern on airport performance being affected by third parties in its response to the whitepaper has not been noted by the Authority. As an airport is a function of diverse entities including security agencies like CISF, Immigration, Airline personnel, Ground Handlers, ATC personnel etc., it is inevitable that the performance of these entities in the airport will affect the level of performance of the operator. We would like to highlight here that the memorandum of understanding that is required to be signed between the airport operator and the various Government agencies as per clause 3.6 of the SSA for signing of MoUs between operator and Govt agencies. This is still not executed. AERA should take cognizance of this while monitoring ASQ levels. This is especially true in subjective service quality ratings, but also applicable for some objective ratings including availability of parking bays, aerobridges, security check, check-in, baggage delivery etc. In the absence of the operator's ability to enforce service level agreements on many of these entities inside the airport, it is unfair to expect the operator to face penalties on account of these issues. If Authority were to address the problem of service quality penalties and incentives comprehensively, it should isolate the root causes of the underlying issue and impose SLAs on all entities concerned. In case Authority finds that this is outside the ambit of its mandate, it should at least tread carefully in penalizing airports for poor performance, in the initial period.
- 8.5 The concession agreements of various airports have different sets of metrics for objective and subjective service quality parameters. The agreements of DIAL and MIAL specify compliance with a range of parameters, failing which the operators are required to pay stringent penalties to AAI. Enforcing an additional level of penalties would be akin to double jeopardy. The Authority should explicitly clarify that only one level of penalties would apply on service quality parameters
- 8.6 A subjective service quality rating at any airport is a function of overall passenger experience. Notwithstanding the rigor employed in devising the survey, it cannot be treated as a quantitative metric based on which an airport's tariff levels can be based on. APAO recommends that subjective service quality metrics be tracked only for the purpose of investigating root causes of lacunae, and for addressing them through investments and process level changes.
- 8.7 While objective service quality standards have been clearly spelt out, the Authority has missed to note the seasonality and periodicity of the same. For example, it is not clear if the measurements are to be made at average levels or peak levels of performance, and whether at a single period or over multiple periods.
- 8.8 Further, as noted in this paper, the linkages between service quality and capex has missed an elaborate discussion in the consultation paper. The cost required for every marginal improvement in objective service quality parameter will be exponential, and it is not clear as to how the authority arrived at a particular benchmark (for example, availability of automated services at 98% etc.) It is not clear again, if the Authority has performed a cost-benefit analysis of providing the level of service that has been asked for, which can be different for different airports. APAO puts on record its objection that these metrics cannot be standardized across

airports, and should be seen in conjunction with the specific capex plan for each regulated airport.

- 8.9 If the Authority were to treat these metrics as sacrosanct, it should logically follow that the costs required for these services, designed for the worst case performance of the third parties (like airline delays in check-in counters etc), should be treated as a pass through to the airport users. However, this outcome will be sub-optimal for the users, for whom the costs may far outweigh the marginal benefits for the users. It is recommended that Authority prioritize the top items that merit closer attention for immediate tracking, and only track the others based on identified needs, instead of starting with a list of prejudged metrics of performance. In this context, our recommendation would be to segregate the service quality parameters into two grades – critical parameters and good behavior parameters. Incentive/ Penalty mechanism should be applicable to the critical parameters which should at the most be 8 to 10 key performance parameters that can be efficiently monitored by the airports. We would like to highlight that some well known airports such as Paris Airport have a limited set of performance parameters that are used to monitor performance.
- 8.10 Further, we recommend that the Authority recommend a trajectory of achievement of service quality metrics. For example, as provided in the OMDA, DIAL and MIAL are required to meet different service quality points at different years. The check-in time at queue for 95% of passengers should be 20 minutes within 2 years and within 10 minutes within 5 years. Such a graded estimate, rather than point estimates provides an opportunity for the airport operator to calibrate their processes and assets and optimize them for the fast evolving needs of passengers. We would like to highlight that in case of BAA, quality standards were imposed 10 years after start of the airport.
- 8.11 Penalties of service quality should be tied to the bottom-line of the airports, as this would penalize excessive profits made at the expense of service quality. The current approach suggested by the regulator to penalize the revenues would be regressive.
- 8.12 We would also like to highlight here that on certain service quality parameters, it is very difficult for airports to cross a given thresh hold. For example in the following examples only a very few airports could achieve an ASQ level of 3.5 or more;
- 8.12.1 Value for money for car parking – 29/ 130 airports
- 8.12.2 Value for money for retail – 11/ 131 airports
- 8.12.3 Value of money for catering – 11/ 131 airports

*It is therefore quite possible that while an airport scores very high on aggregate basis, it is unable to cross the thresh hold on some parameters. We would therefore recommend that the service quality level should be specified at an aggregate level only for penalty/ incentive mechanism.*

- 8.13 Provision of service quality cannot be one-sided and the best system designed should help the airports to reap the advantages of service quality. Therefore, the incentive system should be recalibrated so that a penalty of a maximum of 1.5% of monthly revenues is re-stated with a mean of 0% and extremes of +/- 0.75% (say) on the monthly profits.
- 8.14 In summary, APAO notes with concern that the design of service quality metrics should not be hastily undertaken. Since the five major airports are in the investment mode, it should tread carefully in this direction keeping in mind the externalities, controllability, materiality, utility to end passengers and a learning trajectory that is involved in achieving world class service quality. We strongly recommend that the incentive/disincentive system for service quality be deferred for a minimum period of one review period, allowing the airports to understand their operations much better in tune to these metrics and make the requisite interventions.

## **9 Depreciation**

- 9.1 Authority has indicated that it intends to use a straight line method of depreciation as per the Companies Act or “other evidenced sources”. However, the Authority has not responded to the specific concerns of the airport operators which are as follows:
- 9.1.1 Companies Act leaves a wide room for interpretation on the appropriate rates to be used for assets used continuously. Judging from the response, all stakeholders have responded positively to using the useful life of the asset into consideration, while providing for accelerated depreciation caused by continuous use.
- 9.1.2 Advance against depreciation, which is an important concept in the power sector to meet the debt repayment requirements has not been considered by the Authority. In fact, non-consideration of the same would mean that the operator would be left with insufficient cash flows to meet the loan repayment schedules and would in turn lead to sub-optimal gearing. This would ultimately lead to increased cost for the airport users.

## **10 Operating Expenditure**

- 10.1 Authority in its discussion of operating expenditure has noted the concern raised by APAO on the linkage between operating expenditure and service quality, and the consequent difficulties that would arise in ensuring a high level of savings, while ensuring superior quality of service. Further, the observation by CII regarding a trajectory of achieving efficiency and the comments by Planning Commission that “qualitative information”, together with the “uncertainties involved” and the need to make savings without “affecting the service level” assume significance.
- 10.2 In Clause 8.27, the Authority has indicated in passing that its use of benchmarking analysis would include among its elements a test on service quality, in the medium term. However, it has rightly noted in clause 8.30, that in the short term, its focus would be on the individual submission of the airport operators.
- 10.3 In this context, the authority notes that it would “incorporate potential efficiency improvement at an aggregate level based on data availability especially in the first control period”. It further discusses on the need to separate controllable and uncontrollable costs, and the multiple approaches that it would employ for

estimation of controllable costs. However, the Authority has not indicated how it proposes to implement the same.

- 10.4 APAO requests that the following be given due consideration.
  - 10.4.1 In meeting mandatory subjective service quality standards that affect passenger perception, the airport operators would need to spend on several elements that may not necessarily be seen as “efficient” by all stakeholders, especially because the output is not immediately measurable. It is in this context, that service quality and efficiency may become divergent objectives for Authority to enforce, at least to begin with. There is a learning trajectory that all airports have to go through, in order to understand the fine balance that is required to meet the passenger expectations through focused expenditure. It is APAO’s submission that only after this point is reached, should efficiency become an important factor to determine tariffs.
  - 10.4.2 The authority should provide a detailed list of costs that it would consider as uncontrollable. This should include all expenses that are required for meeting the required subjective and objective quality standards. Since airports are lumpy investments, there would be a need to maintain the excess capacity at a minimum level, till the point such assets become completely utilizable by growing traffic. Further, costs that are required to meet exchange risks, to overcome under-performance by allied parties etc. can also become candidates for uncontrollable costs
  - 10.4.3 APAO would like to submit that since the airport operators would need some time to understand the operational expenditure related efficiency requirements under the regulatory regime and build their cost structure around that, the first tariff cycle may allow operational expenditure on actuals.
  - 10.4.4 It is a well recognized fact that despite best efforts made by the businesses, there have been problems in collection of revenues. In recognition of this fact, APAO requests that Authority may allow provision for bad debts to be written off in the tariff determination regime.
  - 10.4.5 The efficiencies achieved by airport operators during one tariff cycle, if taken as the benchmark for next tariff cycle by default, would reduce the motivation of airport operators to achieve efficiencies. We would recommend that the benchmarks for the next tariff cycle should be slightly lenient compared with the efficiencies achieved by the operator.
- 10.5 Treatment of Tax liability on Revenue Share

Revenue share to be paid by some airports to the AAI would be treated as an expense in the hands of airport operators by the taxation authority. Accordingly, the tax incidence on airports would come down to that extent. APAO’s submission in this regard is that since revenue share is not recognized as a cost pass through by the Regulator, the tax savings on account of this cost should also not be part of the tariff determination process i.e. as revenue share does not form part of the allowable aeronautical revenue to be recovered, similarly the savings on account of lower tax incidence should be kept out of the allowable aeronautical revenues.

APAO submits that the debate on operating expenditure is far more detailed to be taken up at a philosophical level at this stage. It requests that Authority hold a focused consultation with all airport stakeholders on this element at a later stage.

## **11 Non-aeronautical revenues**

- 11.1 APAO fundamentally disagrees with the philosophy of single till for the private airports with concession agreements, and instead submits that the provisions of the agreement in the airport be given due consideration. In case of Greenfield airports BIAL and GHIAL there is no element of cross subsidization. However, in the case of DIAL and MIAL, where a hybrid till is indicated, it may be necessary to take into account projections of non-aeronautical revenues for a limited cross-subsidization.
- 11.2 In clause 10.2, APAO notes that the authority has indicated that the level of non-aeronautical revenues would need to be incentivized. In Clause 10.4, it has indicated that the same would be implemented by reviewing the business assumptions of airports, and setting a benchmark level, leaving it to the airport to exceed this potential. However, it has also argued that the authority may independently alter these projections and determine the final forecast.
- 11.3 APAO strongly opposes the above position on the following grounds.
  - 11.3.1 Commercial and retail activities are the more risky side of the airport business. APAO fundamentally objects to the mixing of this business with the less risky infrastructure side. However, if such a position has to be adopted to align with the provisions of the concession agreements, the projection of non-aeronautical revenues would be a serious challenge for all airport operators. During the recent downturn, non-aeronautical revenue potential collapsed around various airports, pointing to the fact that the best effort projections of all airports may fail under extreme circumstances. If the assumed revenues were to further cross-subsidize the aeronautical side, the risks for under-performance is multiplied manifold, and may seriously question the viability of operations. Therefore, incentivization by normative projections is a double-edged sword, as it also increases the risks of under-achievement for the airport operator.
  - 11.3.2 Given that the consumer behavior of Indian airport passengers has not been fully understood, it is unlikely that any independent evaluator would be able to provide a better evaluation of the commercial potential than the airports themselves, who undertake the risks. Forecasting errors on retail and commercial activities is extremely high given the mix of several services provided at airports, and APAO argues that the likelihood and quantum of upside errors would far outweigh the intended incentivization benefits.
- 11.4 APAO proposes the following as alternate methods to incentivize non-aeronautical revenues
- 11.5 On an ongoing basis, Authority should rely on the actual data for achievement of non-aeronautical revenue for the purpose of tariff fixation. This would include truing up of non-aeronautical revenues at the end of every review period, for the purpose of aeronautical tariff fixation.
- 11.6 Also, in case there is a significant difference between the non-aeronautical revenue estimates submitted by the airport operator and the assessment of the Authority,

the Authority may allow a true up of the same as and when actuals become available.

## **12 Form of price control and tariff structure**

APAO welcomes the approach taken by the Authority to fix tariffs at an aggregate level. However, APAO requests clarity on the following:

- 12.1.1 Considering that Passenger Service Fee is proposed to be re-designated as a pass through charge for security components, airports should be free to design and implement other charges to recover the costs for providing infrastructure to the passengers. These may be for example, via a single charge like a user development fee, or through other infrastructure charges, specifically payable based on usage. We believe that since PSF charges are only security based while UDF charges are case based, there should be a passenger based charge component as well in the tariffs.

## **13 Conclusion**

APAO, while welcoming the stand of the Authority in setting for itself well-articulated objectives, notes that the approach would need to be fine-tuned to ensure that these objectives are being met. In particular, the following are the summary of the important positions set out in the paper

- 13.1 Grandfathering of all concession agreements and bid assumptions taken prior to the advent of the regulator and respecting sanctity of contracts for the entire duration.
- 13.2 An overall approach that seeks to mitigate the risks for airport investors rather than to price these risks as cost of capital
- 13.3 Requirement to test all regulatory decisions against clauses 3.6 a) and c) of the paper that sets out the objectives for facilitating the wider policy aims of the aviation sector
- 13.4 Complete adherence to test all regulatory decisions against clause 3.8 b) that seeks to bring greater predictability and consistency of regulatory decision making
- 13.5 Need to consider the differential impact of regulatory decision making on all stakeholders, and in particular the fact that the materiality of airport charges is minimal on airlines, while it is highly significant to the materiality of airport operations
- 13.6 Requirement of Authority's increased involvement and support to achieve certainty on various processes including user consultation and future capital investment
- 13.7 Requirement of a flexible approach towards service quality, while recognizing the key linkages between service quality and operating expenses and capex and ensuring that only those parameters that cause material impact on passenger's experience and comfort be tracked.

## 14 Annexure 1: Paris airport – Single Till to Dual Till

- **A greater incentive for the competitiveness** of the group benefitting its customers :
  - a fair share between Aéroports de Paris and air carriers of the value created through the company's efforts and growth in the business: efforts undertaken with regard to retail activities and traffic growth would bring value to ADP, unlike the single-till system
  - helping to establish a direct and strong incentive for Aéroports de Paris in the value created from growth in the business to boost its competitiveness and attractiveness with regard to its customers in order to promote conditions in favour of traffic growth
  - a significant motivational factor for the company and its employees to continue dynamically with efforts undertaken with regard to retail activities, thus promoting customer satisfaction
  
- A genuine **lever for the development of the business, investment and employment**:
  - investments to develop and improve the terminals combined with reasonable profitability in aviation and the prospect of creating value across the retail business increasing Aéroports de Paris' incentive to invest and thereby promoting business growth
  - for this reason, switching over to a dual-till approach as recommended by the working group chaired by Claude Martinand in 2002\*
  - a major issue for employment: retail and catering businesses represent nearly 7,000 jobs at CDG and ORY, quasi-proportionate to the volume of activity
  
- A price signal on fees that has a more direct link to infrastructure and services costs and their development, **promoting economically sound and responsible behaviour** :
  - for this reason, adjusting the regulated scope as recommended by the Cour des Comptes in 2008

Source: *Economic Regulation Framework of Aéroports de Paris : current status and prospects 1<sup>st</sup> February 2010*