



Association of Private Airport Operators

Industry Response to AERA Whitepaper on
Regulatory Objectives and Philosophy in
Economic Regulation of Airports and Air
Navigation Services

05th January, 2010

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1. Background

The Airports Economic Regulatory Authority (AERA or the Regulator) has issued a Whitepaper on “Regulatory Objectives and Philosophy in Economic Regulation of Airports and Air Navigation Services” on December 22, 2009.

In the aforesaid white paper, the Regulator has deliberated on multiple aspects covering various issues of airport economic regulation, and has invited response on items including:

- Form of regulation
- Till Treatment (Single, Dual, Hybrid)
- Fair Rate of Return
- Capital Investment Procedures
- Operating Expenditure
- Form of Price Control and Tariff Structure
- Passenger Charges and Airline Charges
- Service Quality Monitoring

We would like to commend AERA on coming out with a comprehensive whitepaper which discusses the above issues along with citing international examples at various places and bringing out the pros and cons of different regulatory choices.

Response to the above Paper is expected by 5th January, 2010. While this timeframe is relatively short, we believe that the Regulator would come out with notes on individual issues in greater detail going forward. We would request the Regulator to keep us involved in the consultation process by providing us a chance to respond to the notes on individual issues that are published in future.

We understand that this White Paper will form a basis for the regulatory approach to be adopted by the Regulator in future. We, therefore, consider this Paper as an important milestone and we are submitting our response on the various issues highlighted in the sections below.

2. Putting the industry context in perspective

Regulatory philosophy and principles must be developed in the context of the state of the industry and the policy intent of the Government. A recent statement by Mr. M. Madhavan Nambiar, Civil Aviation Secretary, GoI during the US-India Aviation Partnership Summit in Washington, 8 December, 2009, articulates the need of the sector:

“India requires \$30 billion in airport infrastructure investments.

Kolkata and Chennai airports will undergo improvements and 35 other city airports have been proposed for upgrades. On top of planned upgrades for existing facilities, India aims to build 11 new greenfield airports.

Domestic traffic could grow to 160 million - 180 million operations a year by 2020 [from around 80 million in FY 2009], based on analysts' predictions.”

Further, the Policy on Airport Infrastructure recognises the need for private investment including foreign investment in the airport sector as shown by the following excerpt:

“(14. Financing of Airport Infrastructure – Clause ix) - In the final analysis, looking at the quantum of investment required, the answer to all the problems lies in the infusion of private (including foreign), investment in this sector. This needs to be encouraged by adopting a flexible and positive attitude towards such proposed ventures. The possibility of international aid and cooperation for building of new airports or for modernization and upgradation of existing ones will be seriously explored.”

Investments of such scale are possible only when the private investors see sufficient incentives to enter the sector and more importantly, are assured that the incentives shown by the Government would be maintained under the regulatory mechanism.

AERA's stated objective is also aligned with the above philosophy and as quoted in the whitepaper - *“The basic objectives of AERA are to create a level playing field and foster healthy competition amongst all major airports (government owned, PPP –based, Private), encourage investment in airport facilities, regulation of tariffs of aeronautical services, protection of reasonable interests of users, operation of efficient, economic and viable airports.”*

While it is appreciated that the Regulator, as in any other regulated sector, should seek to balance the interests of investors and users, this balancing act is fraught with challenges and risks; this is especially so in a nascent sector like the airport sector in India. There would be pressures demanding populist measures and it is only too easy to succumb to such pressures. This would be detrimental not only to the airport operators, but in the long run to the entire aviation sector including all stakeholders as airport investments would suffer, ultimately leading to sub-optimal capacity creation and poor service quality levels.

While AERA undertakes the task of developing the airport regulatory framework, it is important to recognise that aeronautical charges have been observed to be less than 4% of the operating costs of the airlines world over, for the last 25 years¹. These are even more immaterial at the passenger level.

¹ ACI estimates <http://www.aci-europe.org/upload/charges.pdf>

There is no empirical evidence of airport charges having any adverse impact on the aviation sector as such. While AERA strives to achieve the regulatory balance between investors and users, this important statistic shows how the risks of erring on either side will impact the stakeholders – a tilt against investors amplifies negative outcomes for them while leading to hardly any observable benefits to the users.

As AERA begins this important journey, we would like to emphasise that this first step is crucial for the following reasons –

- First, in a situation where the regulatory disposition is seen to go against the overall policy statements of the government, or renege on existing contracts or are in variation with existing business assumptions; future investors perceive an increased regulatory risk, increasing the cost of these investments. For international investors, such decisions may also increase the sovereign risk for the country.
- Second, such regulations may set precedents for future decisions by creating a case law, and any errors in the initial set of regulations will have a cascading effect for future decisions over a protracted period of time.
- Third, if the outcomes of the regulations negate the policy incentives offered by the government, investor appetite in the sector will abate, which will work more seriously against maximization of consumer welfare, than any short term incentives offered to them by way of reduced prices.

The international investor community is watching how the regulatory landscape will evolve. It is our humble request to AERA that the context of the sector and the policy intent of the Government be kept in mind as the regulatory framework is evolved. A key test for the regulator would be to face the following question ten years hence:

- Has the sector attracted the much needed investments that were envisaged?
- Have Indian airports stood up to the expectations of a resurgent India?
- Can Indian airports stand up to the efficiency and service levels of the best airports in the world?

An affirmative answer to the above would be the trophy for the regulatory framework we adopt today.

In subsequent sections, we provide our comments on specific issues raised in the whitepaper.

3. Preamble

In line with AERA's stated objective, we believe that the Regulator must imbibe the principles enunciated below.

- 1) The regulatory approach must ensure self-sustainability of each airport such that while the Regulator adopts a common set of principles for regulating airports, it may differentiate between the regulatory treatment for each airport based on the specific situation of each airport e.g. regulatory treatment of an airport with revenue share may be different from an airport without revenue share
- 2) The Regulator, if it feels necessary to do so in the interest of discharging its duties efficiently, may modify the terms and conditions listed in the various concession agreements signed by Airport Operators, however, in doing so the Regulator should ensure that the Airport Operator is not made financially worse-off than he was with the original terms and conditions
- 3) Given the symbiotic relationship between Airlines, Customers and Airport Operators, it is the inherent interest of the operator to ensure viability of these stakeholders. The Regulator should, therefore, allow sufficient flexibility for the airport operator by regulating at an aggregate level rather than a micro level e.g. tariff determination may be done at an aggregate level rather than tariff determination for each service
- 4) The Regulator should base its understanding on the stand of the regulators in international matured markets and take into consideration the well-documented experiences
- 5) The True-up process to take care of deviations in actual versus estimated revenue fluctuations must be objectively defined. Risk allocation framework of allocating risks including traffic and other controllable/ non-controllable items should be laid out. In this regard, our suggestion would be that on factors beyond the control of the airport operator such as passenger traffic, changes in operating cost etc, the Airport Operator must be allowed upsides and downsides within a band beyond which the impact may be trued up.

In the subsequent sections, we have responded to (i) issues considered critical to establishing a successful economic regulatory regime for airports and air navigation services in the country as identified on page 67 of the white paper and (ii) other issues that we believe would be key to a successful regulatory approach.

4. Form of Regulation – Price Cap/ Rate of Return/ Light Touch

To begin with we would like to submit that even under a price cap approach wherever there is a need to determine the initial price levels, at least a one-time estimation based on a rate of return method is required. In that respect, the two approaches are not mutually exclusive.

We would also like to highlight that the illustrative price cap approach as specified in the concession agreement of Delhi and Mumbai combines two different approaches and is not a pure price cap approach.

We compare the price cap and rate of return approach to arrive at the pros and cons of both in the table below.

Price Cap	Rate of Return
More suited to mature sectors with high stability and less scope for structural changes that have a significant bearing on the cost of operations	More suited to nascent sectors with evolving changes that necessitate a more frequent and deeper review of cost structure
This system, by its design, can distribute the impact of sudden rise in costs over a time frame spanning multiple years thus smoothening out any potential tariff shocks	<p>Since this system adopts the principle of allowing regulated returns over and above judicious costs, the system does not have enough flexibility to dilute the impact of a tariff shock by spreading its impact over multiple years.</p> <p>Although it would be relevant to quote here that Regulators in other sectors have evolved mechanisms within this system to dilute the impact of potential tariff shocks</p>
In this system, setting the initial price point becomes crucial as once the initial price point and 'X' factor have been determined the only factor that changes over the control period is the inflation	This system lends itself better to rectifying any errors in initial price point setting as it provides opportunities for reviewing the entire cost base on a periodic basis.
Cash flow mismatches can happen in a price cap mechanism with the regulated entity generating surplus cash in some years and deficient cash in other years	Less scope for cash flow mismatch – except for a few areas such as differences between depreciation and principal repayment which can be rectified through adoption of certain principle, the scope for cash flow mismatches is minimal

Our considered opinion in this regard is that the regulatory approach must ensure the following:

- The mechanism must possess the requisite flexibility to adapt itself to a changed cost structure e.g. if a lumpy investment gets commissioned in the middle of a control period, the mechanism must be able to reflect the cost of such a change in the tariff structure as early as possible
- The mechanism must not result in cash flow mismatches. In case these cannot be avoided these should be as low as possible and should provide the airport operators a means to finance the cash flow mismatches
- We would request the Regulator to keep us involved in the process followed to arrive at a suitable regulatory approach to tariff fixation as this approach would largely determine the acceptability of tariffs for both concerned stakeholders as well as airport operators

5. Single/Dual/Shared Till Approach

The Till approach adopted by Regulators is perhaps the most critical factor that determines the attractiveness of airport operations. Airport Regulators worldwide have devoted extensive time and effort to this subject and have learnt from the experiences of other airports.

A specific case in point that we would like to highlight here is the case of Heathrow Airport – an airport situated in the UK, a country that is supposed to be a ‘poster boy’ of efficient regulation. Under the Single Till Approach, the Heathrow Airport Operator is finding it economically expedient to pay the penalties of GBP 7 million for poor service quality rather than invest in aeronautical assets, which do not provide returns to the operator.

We have strong reasons to believe that a dual till approach must be followed in the current regulatory context. Our reasons are listed below.

Dual-till supports the Government’s vision of encouraging private investment

As brought out earlier, regulatory approach to incentivization must be consistent with the Government vision and policies which have clearly identified the compelling need for private investment and management expertise. This is best achieved under a dual till regime as the returns on the non-aero side of the business provide the much needed upside on returns. This is exemplified by numerous international examples which show that dual till regime is seen to encourage investments and are more suited to situations where airports are congested. Importantly, this will be in line with the expectations that investors had at the time of signing the concession agreements.

Dual-till provides a hedge against uncertainties in Aviation Sector in India

Aviation sector, though not new to the country, has witnessed a structural shift in the past few years. The low-cost airline format has had a profound impact on passenger traffic necessitating large investments to meet traffic growth. At the same time, the challenges of a weak global economy, declining traffic levels, and deteriorating financial health of airlines have added to the overall uncertainties of aviation sector. While the growth is strong, it is also volatile as shown in the following table²:

² Source: AAI Website

All India Statistics	YOY Growth							CAGR
	FY 2003	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	
Aircraft movement	10%	14%	12%	17%	28%	22%	0%	16.97%
Passenger Movement	9%	12%	22%	24%	31%	21%	-7%	18.18%
Cargo traffic	15%	9%	20%	10%	11%	10%	-1%	12.11%

Airport infrastructure investments are lumpy investments and require careful estimation of future traffic projections to ensure optimal use. Also, the magnitude of the investments required make the Banks/ Funding Agencies cautious in lending and any uncertainties results in either constrained funding or a high debt premium or both. Dual till, as a regulatory approach, has been put to good use by some countries to ensure that the Airport Operators don't face a fund crunch at the time of readying the airports for future.

In the Indian context, if we compare the volatility in traffic of Indian airports with the volatility in traffic of top ten airports of the world in terms of passenger traffic as shown in the table below, we realize that Indian airports have witnessed not only higher increase in traffic movement but also higher swings in traffic year on year.

Rank in 2008	City (Airport)	CAGR Pax growth 2004-2008	Max % Change YOY 2004-2008	Min % Change YOY 2004-2008
1	ATLANTA GA (ATL)	1.87%	5.7	-1.20
2	CHICAGO IL (ORD)	-2.11%	8.7	-9.00
3	LONDON (LHR)	-0.11%	6.1	-1.50
4	TOKYO (HND)	1.75%	4.4	-0.90
5	LOS ANGELES CA (LAX)	-0.49%	10.4	-4.70
6	PARIS (CDG)	4.39%	6.3	1.60
7	DALLAS/FORT WORTH TX (DFW)	-0.99%	11.6	-4.50
8	FRANKFURT (FRA)	1.14%	5.7	-1.30
9	BEIJING (PEK)	7.08%	18.7	3.80
10	DENVER CO (DEN)	4.85%	13	2.60

In comparison with the table above, Indian airports have shown rate of growths varying from as high as 31% to as low as a negative growth of 7% in passenger traffic in the last five years. This makes investment decisions risky in the case of Indian airports, even more so as compared to international airports – the growth rates in India make a compelling case for speedy investments

while the volatility in traffic creates a potential risk of the investments not earning their due returns.

Keeping the uncertainties as listed above in mind, it would be safer to adopt a dual till approach as it not only helps airports in becoming more financially viable but also increases investor interest, lowers the overall cost of capital and spreads volatility risks over different revenue sources.

Revenue Share to AAI by Delhi and Mumbai Airports is in effect a cross subsidy

Mumbai and Delhi airports are providing 38.7% and 45.99% of their revenues respectively to the Airports Authority of India on a top-line basis. This flow of money represents more than 50% of AAI's current profits on its entire account (that includes operation of airports and air navigation services). AAI is managing over a hundred airports from this account, and it is clear that a de-facto cross subsidy system has already been enforced on these private airports, where a sizeable chunk of the revenues from Delhi and Mumbai go towards meeting the aeronautical expenditures of other airports. As we show through some examples in the subsequent sections, revenue share combined with a single/ hybrid till completely eliminates the viability of these airports.

We are therefore arguing that in the interest of viability of operations, the Regulator should not impose a further cross-subsidization within these airports by imposing a single till.

Indian airports to take time to develop non-aeronautical revenues

As demonstrated in White Paper - Clause 4.61, Indian airports have a long way to go to catch up on the non-aeronautical revenues with the major airports³, and as such, the scope of cross-subsidies is fairly limited.

Our submission, therefore, is that sufficient regulatory incentives must exist for the airports to develop non-aeronautical services. This is especially pertinent in the context of Bangalore and Hyderabad airports which are greenfield airports while in Delhi and Mumbai there was no thrust on non-aeronautical revenue development pre-privatization. Encouraging development of non-aeronautical services in these airports would, therefore, largely be governed by the 'push' provided to concessionaires by airport operators in the form of incentives. The airport operators, in turn, would be encouraged by a dual till approach.

Experiences of more mature aviation sectors

Regulators of the two most mature regimes – UK and Australia have voiced their concerns over single till approach. Clause 4.91 of the whitepaper also recognizes the issues involved in a single till approach. Our request to the Regulator would, therefore, be to draw inferences from more mature aviation sectors so that aviation sector in India can take off in a smooth manner and not be a bumpy ride that is symptomatic of too much experimentation and frequent track changes.

Specific response to Clauses 4.82 and 4.83 of the White Paper

³ While it is quoted that airports like Delhi International Airport Limited (DIAL) have 41% share of non-aeronautical revenues, these estimates are based on past tariffs and will significantly reduce once new aeronautical tariffs are in place.

White Paper Quote – *“In principle, provided non-aeronautical activities can generate above-normal profits for the airport operator, a dual till would create incentives for the operator to create additional capacity at a capacity-constrained airport to maximise the numbers of passengers (or freight volumes) paying for nonaeronautical services. Empirical analysis suggests this effect is real and that the effect of capital underinvestment in congested airports under a single till reduces overall productivity.*

Other analyses suggest that, at uncongested airports, the single-till regulation comes closer to maximizing welfare than dual-till regulation”

While the paper on ‘Competition Commission: BAA London Airports Inquiry’ demonstrates the effect of single till on increased congestion conclusively, the other paper on ‘Price-Cap Regulation of Airports: Single-till versus Dual-till’ is ambiguous in its conclusion. While social welfare is said to be maximised by single till, it is achieved at the expense of compromising on optimal profitability of the airports.

It is to be noted that the second paper does conclude that economically efficient pricing – where social welfare is balanced by economical operation of airports (Ramsey prices) are not achieved in both cases. The stated objective of AERA to balance the interests of investors (“operation of efficient, economic and viable airports”) and the users (“protection of reasonable interests of users”) is not achieved by adopting single till

Further, while the first paper is based on empirical evidence on a set of airports around the world, the second paper is largely academic and based on a number of assumptions. Empirical evidence especially in mature markets strongly argues against single till.

Specific response to Clause 4.95 of the White Paper

White Paper quote – *“Operating expenditure, revenues and assets may need to be allocated between aeronautical and non-aeronautical activities in case dual or hybrid till approach is adopted. The allocation methodology would need to be specified in terms of scope of activities within each till, the methods of identifying and recording direct costs, revenues and assets with respect to such activities and the basis of allocating shared and common costs and assets.”*

We believe that difficulty in arriving at an allocation methodology cannot be a serious objection to dual till as there is a long precedent for cost allocation methodologies across dual till airports, and the margin of error if any in allocation of costs are not likely to be material.

Regulators in other sector have evolved detailed cost allocation methodologies in equally or more complex scenarios. As an example, Electricity Regulators in India have evolved cost allocation methodologies to segregate costs between wires business (the distribution network) and supply business (provision of electricity through the use of wires business and ancillary activities such as metering, billing to consumers). It would be pertinent to mention that these are highly intertwined businesses in the current mode of operations of most distribution utilities in India.

Our Submission on the Till Approach

Based on the above points, we strongly recommend a dual till approach based on the following factors:

- The Regulator must build in the Government’s vision of encouraging private investment in airport infrastructure in its regulatory approach through provision of right incentives to private investors
- A single till approach would lead to very low and possibly even negative returns on investments in aeronautical assets. This is especially true for those aeronautical assets that do not have any scope of earning non-aero revenues. This in turn would encourage compromises on aero investments and service quality ultimately encouraging aero assets to be stretched beyond their optimal utilisation levels leading to congestion. This is exemplified by the Heathrow airport example and is something the Indian airport sector can ill-afford.
- The Regulatory mechanism should facilitate the Airport operators in generating cash flows on the non-aeronautical side to make the airports financially stronger.
- With the revenue share clauses in the concession agreements of some airports as detailed in subsequent sections, these airports are anyway cross-subsidizing the operations of other airports. Building a further cross subsidy between aeronautical and non-aeronautical revenues would seriously jeopardize the operations of airports.

6. Fair Rate of Return

White Paper Quote – (Clause 4.98) *“The setting of tariffs for aeronautical services in respect of major airports would need to consider the reasonable expectations of investors of a fair rate of return. As with any commercial investment, such a rate of return may need to have reference to the level of performance.”*

We would like to state that level of performance cannot have any bearing on the cost of capital of an airport. It is best measured via penalty/ incentive mechanism for efficient operations and service quality considerations rather than tying it to the rate of return.

While OMDA specifically discusses the penalties applicable to the airport operator for under performance, there is no mention of the upsides applicable in instances of performance better than specified service levels. Any incentive/ penalty mechanism, to be workable, must allow incentives also if penalties are put in place. Our suggestion would be that the Regulator develops a balanced incentive/ penalty mechanism.

White Paper Quote – (Clause 4.98) *“In determining a fair rate of return, developments in financial theory and practice, the need for an evidence basis for assessments and a dialogue with the investors and other interested parties is necessary. A fair rate of return, sometimes called the cost of capital, would need to be sufficient to attract funds for investment in airport facilities. This is an important parameter in determination of airport tariffs”*

We believe that Rate of return cannot be the subject of subjective interpretations of economic conditions from parties who have not actually committed money to the project. Rather, rate of return should be based on sound economic principles, and on past actual evidence of cost of investment on similar projects under the same economic conditions.

White Paper Quote – (Clause 4.101) *“The process of regulation, could itself significantly protect investors from key aspects of risk. Notably, the periodic review of airport and aeronautical services tariffs provides mechanisms for risk to be shared between an airport and its users – subject to safeguards to protect users.”*

We tend to disagree with this generalizing statement, as regulation is also a source of key risks for investors (collectively and popularly termed “regulatory risks”) which are one of the principal elements of a due diligence process.

This is especially of true of the current context, where investors have committed to projects at a time when the tariff structure under eventual regulation was a key unknown. Indeed, the high cost of capital that many airports have been facing may partially be attributed to the uncertainty of these investors with regard to payback on these investments under varying regulatory outcomes.

The quoted statement may only be assumed to be correct once the regulatory process is firmly established in a mature regime, where sufficient past evidence in the form of case law, can lead to greater certainties for the investor.

7. Capital Investment

White Paper Quote – (Clause 4.111) *“Clause 8 of Schedule 1 to the SSAs for Delhi and Mumbai also provide that “AERA will accept the Master Plan and Major Development Plans as reviewed and commented by GoI and will not seek to question or change the approach to development if consistent with these plans. However, the AERA would have the right to assess the efficiency with which capital expenditure is undertaken”*

While AERA is entitled to conduct a review of the efficiency of capital investment, according to the agreements of Delhi and Mumbai airports, the operators are required to conduct a benchmarking exercise of their own and have it certified by an Independent Engineer appointed by the Government. In the same vein, Lenders Engineers have examined the justification for capital expenditure and monitored the efficient utilization of funds for Bangalore and Hyderabad airports. In this regard, AERA may review the work done by these airports/ agencies and assess the sufficiency of the same.

Valuation of assets taken over at the time of privatization

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 were collectively generating revenues at the prevailing tariffs and therefore had 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. The State Support Agreements (SSAs) of DIAL and MIAL recognize this concept in the form of a ‘Hypothetical Regulatory Base’.

Indexation of Fresh assets added by Airport Operator

The Regulatory practices adopted by some Regulators as mentioned below takes into consideration the evolving market value of fresh assets added by airport operators and indexes them accordingly on a periodic basis to reflect their value based on market potential rather than accounting value.

One of the benefits that can be drawn from such a valuation methodology is in generating funds from depreciation that are sufficient for asset replacement rather than recovering only the book value of asset.

Among the approaches followed for business valuation is the **Optimized Depreciated Replacement Costs (ODRC) approach** that considers replacement costs instead of historic costs, to determine the exact economic value of the asset. This approach, used in Australia considers the cost of creating a new asset of the same functional quality in contemporary terms at the time of every review. This would then be adjusted for the economic life of the asset – in order to reflect the degradation due to depreciation. Such an approach would adjust the computed value of the asset to its closest equivalent in terms of economic costs.

Capital Outgoes

Additionally, there are certain capital outgoes which the airport operators are required to make as part of overall airport development. Airport operators must be allowed to include such capital outgoes in the RAB while calculating the target revenue.

8. Operating Expenditure – Incentives for efficiency improvement and cost pass through

Since the service quality norms are very stringent in the concession agreements, it would be difficult for the airport operator to make savings or show performance improvements. The Regulator should, therefore, take a practical view of the extent of efficiency improvement possible and the resulting savings thereof.

9. Form of Price Control and Tariff Structure/ Passenger Charges Vs Airline Charges

On the form of price control, we are of the opinion that the operator should have flexibility within the 'aggregate' determined by the regulator.

On passenger charges vs. airline charges, as responded earlier, we would like to retain the flexibility to determine the allocation between passenger and airline charges, with the concurrence of the Regulator.

10. Service Quality Monitoring

White Paper Quote – (Clause 4.147) “Many elements are outside the control of the airport operator – such as security, dwell time, check-in and baggage delivery; ...Failure to achieve standards could lead to penalty payments. In such a scenario, up to 4% of airport revenue, both aeronautical and non-aeronautical, could be at risk.”

We wish to highlight to the Regulator that with a penalty mechanism specified by the Regulator there is a possibility of the airport operator being penalized twice – by AAI and by the Regulator

for not meeting the same service quality standard. Such a situation needs to be avoided and elements which are outside the control of the operator need to be taken into consideration.

We would also like to highlight that the service levels specified in OMDA are too stringent in some cases. This may lead to a situation where the airport operator makes significant investments to achieve a certain service level for some services that do not result in a perceptible improvement in experience to customers.

Setting and Monitoring of Standards

White Paper Quote – (Clause 4.154) *“While determining tariffs different service quality parameters may need to be considered for setting up of a synchronized incentive regime. For instance, linkage of the overall incentive regime to service quality may be required to prevent incentives for the airports operators / air navigation service provider to save on costs at the expense of service levels.”*

While AERA has wisely considered service quality in the tariff fixation process, it is important to note that the airport operator is one of the most passive entities in ensuring a smooth running of the airport on a day to day basis. Volatile airline schedules and delays, lack of manpower from security agencies and at airline check in counters and delays from air traffic control have a more dynamic effect on changing the user’s experience than the simple provision and management of infrastructure. Monitoring of service quality should be done keeping in mind similar context of performance, and isolation of responsibilities to controlling and external entities.

Prior to establishing any penalties for under-performance or in withholding incentives for performance, AERA should seek to establish if it was within the ambit of the airport operator to remedy the situation and the means to do it. The operator should not be penalized for perceptible shortfalls of performance, if the appropriate remedial measures that could have been adopted by the operator could not be established conclusively. In particular, we recommend that AERA should set service level agreements with all parties managing the airport including airlines, ground handlers, security agencies etc. so that the airport operator is only made responsible for those elements directly under its control.

Further, we strongly recommend against usage of subjective service quality ratings (ASQ) in the tariff determination process. Experience-based surveys are volatile and may not pinpoint the source of dissatisfaction of a particular user segment, and linking perceptible metrics to the tariff process will only subject the airport operator to volatility and unpredictability. Stringent objective service quality requirements are provided in the concession agreements which would serve as better metrics to be used in quantification of tariff levels.

11. Revenue Share

Revenue Share should be allowed as a cost pass through on account of the following:

- Post Revenue share, the net revenue recovery (DIAL at 54% and MIAL at 61%) would not sustain 100% costs based on building block approach. The Regulator needs to ensure viability of the Airports under PPP model.

- Revenue share being allowed as a cost pass-through will be in line with international regulatory practices. In case of Italy, the concession fees paid to the Government based on work load unit is recoverable within the building block approach. Similarly, in case of Manchester, concession fees paid as rents to the local council owners is recognized as a legitimate cost.
- Revenue share reduces the ability of the airport operator to leverage its earnings and reach an optimal debt: equity ratio.
- Revenue share mechanism in perpetuity undermines the overall welfare of the airport sector as other subsidized airports sit on the comfort of the cross subsidy mechanism and may not make sincere efforts to become viable.
- Revenue share affects the viability of business as a whole. With diminished returns on aeronautical revenues due to revenue share the airport operator would lose all incentive to invest further in aeronautical assets. Heathrow airport is a real-life example in support of this argument.

Our submission on Revenue Share is as follows:

- Revenue share, as discussed above, affects the viability of airport operations, eliminates incentives of airport operators to invest in aeronautical assets due to diminished returns and constrains the ability of airport operators to reach an optimal debt: equity ratio. Keeping these points in mind, we strongly recommend that revenue share should be treated as a cost pass-through in the regulatory mechanism

12. Cost of Capital

The suggested approach to determining capital returns (or cost of capital) is based on allowing a Weighted Average Cost of Capital (WACC) over the capital (Debt + Equity) employed by the Airport Operator. There are two issues to discuss here – (i) the issue of capital structure and (ii) the cost of capital

Capital Structure

A key point that we would like to bring to the notice of the Regulator in this regard is that the current capital structure of the airports is very specific to the airports and should not be equated with other infrastructure sectors.

- 1) The current Debt: Equity ratio of airports is a result of the extent of financing available to the airport operators over the last few years. It is worthwhile to note that this period has also witnessed one of the most severe financial shocks worldwide that significantly impacted liquidity available to Banks for financing. Under the given scenario, the capital structure of airports is biased in favour of equity/ quasi-equity and that is a reflection of the market realities rather than the desire of airport operators
- 2) We would also like to reiterate here the point made previously that the revenue share significantly constrains the cash available to the airport operator. From a Banker's

perspective, this translates into a lower Debt Service Coverage ratio (DSCR) and therefore lower ability to lend.

The Regulator must, therefore, keep cognizance of the above two points while viewing the current Debt: Equity ratio. The capital structure must be cognizant of the specific situation of the airports and must not be directly based on the norms followed in other infrastructure sectors.

Cost of Capital

Both cost of equity and cost of debt are a function of the risks inherent in the business in which they are employed. Cost of capital typically reduces as (i) the business matures and the risks and uncertainties are better understood and/ or (ii) the overall framework within which the business operates evolves to take care of the risks.

Regulators in other sectors have developed risk frameworks where risk classification is done based on the degree of control that the infrastructure operator had over mitigating a particular risk. Accordingly, the impact of a risk is either trued-up in the tariff determination mechanism or retained by the airport operator completely or shared between the airport operator and other stakeholders. In the context of airports, some of the sources of risks are as follows: (i) traffic variations, (ii) variation in cost of capital, (iii) capital expenditure inflation (iv) operating expenditure inflation (v) volatility in non-aero revenues (applicable for single and shared till) (vi) unanticipated interruptions in airport operations etc. Such a regulatory risk sharing mechanism helps investors and lenders crystallize the financial impact of inherent risks which, in turn, facilitates in aligning the cost of capital with the commensurate risks.

Here, it is pertinent to note that the way in which the aviation sector has been evolving and is expected to evolve would place certain risks on the airport operator that are beyond his control. The low cost airline model, which has had a profound impact on the passenger volumes, is a relatively nascent phenomenon and the complete impact of this model on the sector is yet to be realized. A case in point is the impact of the recently witnessed economic downturn. While the passenger growth was witnessing a sustained increase on the back of low cost operations, the extent of de-growth in passenger volume as a result of the economic downturn was not envisaged.

The point we are making through the above example is that with the dynamically evolving business models of airlines and the investments being made in airports to bring them at par with international standards, there are significant uncertainties in the aviation sector. From an airport operator's perspective, in the absence of a suitable regulatory risk sharing mechanism this would have a profound implication on his cost of capital – Banks would be willing to lend only at higher debt premium and equity investors would also be desirous of returns commensurate with the risks (i.e. a higher risk beta in the stock price).

Additionally, the revenue share mechanism has the potential to increase the overall risk profile of airports. It is easy to conclude that revenue share, by virtue of being senior claim to the airport cash flows increases the cash flow risks to debt and equity investors. Therefore, revenue share has implicitly created a situation of greater financing risks and higher cost of capital, and the phrase "***reasonable return on investment commensurate with the risk involved***" as mentioned in Schedule 1 should be read in this light.

An additional point that we would like to make here is the vagaries involved in development of non-aeronautical revenues. Since the realization of non-aeronautical revenues is highly dependent on consumer's discretionary spending and also includes options for consumers to buy the same articles (that are not meant for immediate consumption) outside of the airport as well, development of non-aeronautical revenues is a riskier proposition than aeronautical revenues.

Our submissions on the Cost of Capital

Our submissions to the Regulator on determining the cost of capital (WACC) are as follows:

- Define a risk framework that identifies the various risks inherent in the airport business and based on the degree of control that the airport operator has over mitigating a risk define the principle for treating that risk i.e. whether it should be trued up, retained by the airport operator or shared between the airport operator and other stakeholders. Our suggestion in this regard is that airport operators submit a risk framework to the Regulator for scrutiny post which the same may be adopted.
- The cost of equity allowable to the airport operators should be appropriately adjusted to take into account the impact of non pass-through of revenue share.
- It would not be appropriate to mimic the capital structure and capital cost of other infrastructure sectors as the airport sector has not yet attained a stage of maturity and there are factors specific to airports such as revenue share that have a bearing on the capital structure as well as the cost of capital.
- The cost of equity to be allowed must provide private airport operators sufficient encouragement to invest in the sector and align with the Government's policy intent of encouraging investment.
- Our suggestion in this regard is that we would submit a proposal on cost of equity to be adopted for Indian airports based on a scientific study that we propose to undertake very shortly.

13. Classification of Ground handling and Cargo services

The conflict between the classification of ground handling and cargo services in Concession agreements and AERA Act have been noted in the White Paper. However, we believe that there are strong reasons for keeping ground handling and cargo services outside the ambit of regulation besides the fact that these services have been listed as non-aeronautical services in schedule 6 of OMDA in respect of Delhi and Mumbai airports. We would like to mention that agreements have already been signed with Ground Handlers and Cargo Service Providers. Any post-facto review of the classification of these services will jeopardize the existing concessionaires and may cause severe downturn in quality of service and defaults by concessionaires

- Competition exists for ground handling and cargo at airports, and the Regulator should seek to regulate only those services for which there is a natural monopoly. We agree with the White Paper suggestion in Clause 4.49 – *“As discussed above, there are cases where certain service providers (for providing ground handling services and cargo facilities) operate under a*

commercial constraint (competition from other players). In such cases, economic regulation may or may not be required to mimic competition.”

It is for the reasons stated above that we believe that Cargo and Ground Handling services should be kept out of regulatory purview and the revenues arising out of these services should not form part of the target revenue determination.

14.Regulatory treatment of ‘Work in Progress’ Assets

While ‘Work in Progress’ (WIP) assets do not qualify for returns, the fact is that they represent equity investment that earn no returns till the time that the asset gets capitalized. Airports entail large investments which implies that significant equity investments remain devoid of returns as long as the assets remain in WIP state.

We would urge that the Regulator looks at potential mechanisms that allow not just Interest during construction (IDC) during WIP stage but also provides returns to investors on the equity capital invested.

15.Definition of “Public Interest”

White Paper Quote – (Clause 4.2) *“Section 13 (2) of the AERA Act provides for AERA to determine the tariff for aeronautical services once in five years and amend them in the interim, in public interest, if so considered appropriate.”*

We would request that it be stated clearly and transparently as to what would constitute public interest. External shocks and other changes in the regulatory context that may make airport operations unviable and ultimately lead to financial distress and disruption of airport services should also be included in the definition of “Public Interest”.

16.Navigation, Surveillance and Supportive Communication

White Paper Quote – (Clause 4.32) *“Tariff determination for aeronautical service pertaining to navigation, surveillance and supportive communication thereto for air management at major airports would need to be undertaken for the Airports Authority of India as the sole provider of this service at these airports.”*

We would request the Regulator to explicitly provide that the same should be applicable to any other provider of Air Navigation Services, in the event that they are authorized to perform the same service in the future.

17>Returns from Non-aeronautical Services

White Paper Quote – (Clause 4.58) *“It is generally supposed that, under conventional cost allocation methods, non-aeronautical activities generate a higher rate of return on their assets*

than the airport's cost of capital. As such, a dual till approach (pure or hybrid) may tend to lead to a higher computation of required airport charges."

We believe that this clause is prejudicial to the tariff fixation process and such a conclusion may not be arrived at without recourse to facts on specific airports, their business risks and their modes of operation

18. Concessions offered by Central Government

White Paper Quote – (Clause 4.65) *"Section 13 of the Act requires AERA to take into consideration "the concession offered by the Central Government in any agreement or memorandum of understanding or otherwise" in determining the tariff for aeronautical services."*

The phrase "taking into consideration" should be interpreted as abiding by the spirit of the agreement, general understanding and assumptions in which bidders competed in the competitive bid process.

19. BIAL and HIAL's option to apply the tariff prevailing at other AAI airports

White Paper Quote – (Clause 4.72) *"BIAL and HIAL opted to apply the prevailing tariff at the other AAI airports on the airport opening date(s), instead of the inflation indexed tariff which would have been on a higher side."*

While this statement is true, it is not complete. BIAL and HIAL opted to apply the prevailing tariffs in the interim period in order to facilitate the opening of the airports in the absence of the regulator, while retailing the right to claim the shortfall once the regulator is operational.

20. User Consultation

We welcome AERA's emphasis on user consultation as an important constituent of airport operations and management. In order to ensure that the consultation process is conducted as efficiently as possible, AERA should prepare detailed guidelines and ensure compliance of due process from all stakeholders. We prefer that AERA be an active third party in the consultation process, in facilitation of the conversation between the airport operators and the users. In particular, the following may need careful consideration

- Information related to security and other related expenses may not be made public by AERA or may not be subject to public consultation at any point in time, without seeking the permission of Ministry of Home Affairs. In this regard, AERA may follow the example of the guidelines followed in the anti-dumping policy of Ministry of Commerce.
- Airport operators would naturally like to maintain the confidentiality of information that is critical to their business strategy. In this regard, AERA should provide reasonable bandwidth for the airport operator by following one or more of the following approaches;

- i) Allow selective submission of information and protection of commercially sensitive information
 - ii) Selectively redact information made available to itself before making public, in consultation with the airport operators on the information received
 - iii) In cases, where information is merely required for authentication and certification, employ the services of independent auditors and third parties who will act under non-disclosure agreements
- Consultation processes should be handled with discretion and be time-bound. Only reasonable suggestions on the subject matter should be allowed in the consultation process. Any opposition to the position of the airport operator at any point in time should be backed by sound economical evidence, and workable suggestions for alternatives provided, wherever appropriate. AERA should ensure that the consultative process does not become a forum for vested interests to unnecessarily derail progress on important items without a sound basis
 - We further propose that the information exchange should be mutual and allow the airport operator to seek from the airlines and other users, critical information pertaining to their operations, to demonstrate the effect of key regulatory decisions or of usage of improved facilities on them. This could include for example, requests for elements of data that can reveal the extent of benefits that airlines are reaping on account of reduced turn around times and hovering times and provision of benefits on the ground. Respecting sensitivity of airline operations, the same may be sought under strict confidentiality agreements, usable only for limited purpose of airport planning, tariff fixation and service quality monitoring.

21. Depreciation

The form of depreciation will depend on the method used for estimation of the regulatory asset base. While the discussion on submission of the method to be used for depreciation is premature at this stage, without understanding the fundamental principles of tariff fixation, we request note of the following principles:

- In the early years of operation, it may be observed that the chosen method and values of depreciation may not match the cash outflows of the operator for debt repayment obligations. In this regard, it may be found expedient to allow an advance against depreciation to front-end the depreciation costs.
- Airport assets are used on a 24 X 7 basis and the depreciation rates used in Companies Act may not be appropriate indices for determining the same. Consequently, the method used for the tariff process should measure the economic deterioration of the asset quality and the need for reinvestment, without necessarily having to mirror accounting or tax methods of calculation of the same. Justified accelerated depreciation should be considered for airport assets. In this regard, it is pertinent to note the approach taken by the Central Electricity Regulatory Commission which, in one of its tariff papers has discussed the following method for calculation of depreciation for a generating station:

“For calculation of depreciation over the useful life of the asset, the loan repayment period (10 years) can be linked to arrive at the rate of depreciation. The above can be achieved by dividing the estimated life of the asset into two parts for the purpose of tariff determination. The

first part would be 10 years (say the loan repayment period) during which the loan capital would be refunded to the investors in the form of depreciation and thereafter the remaining of the asset can be depreciated up to the useful life of asset with a limit of 90 % of asset value (salvage value).”

- The approach followed for asset valuation must allow depreciation funds to replace assets rather than just recovering their accounting value
- Depreciation must be allowed on assets created out of pre-financing methods (Development Fees) and assets transferred from AAI (Hypothetical Regulatory Base) to enable the operator to build a corpus for replacing them in future
- There are certain capital outgoes which the airport operators are required to make as part of overall airport development. Airport operator must be allowed depreciation on such capital outgoes
- Additionally, it is our submission that for assets where depreciation has a direct linkage with the frequency of usage e.g. runways, the Regulator may specify non-standardized depreciation rates to enable the operators of busier airports with heavier wear and tear of assets to repair/replace them faster in line with the requirements

In this response to AERA’s whitepaper, we have responded to some of the critical issues which we believe will have an impact on investor interest and viability of airports. We urge AERA to give careful consideration to these important issues and take a long term view of the sector and align the regulatory framework with the policy intent of the Government to encourage private investment.