ASSOCIATION OF PRIVATE AIRPORT OPERATORS
Regn No. S/64468/2009

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APAO/CP-09/AERA/ 2013-14 Date: 05 August 2013

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Sub: APAO response to AERA's Consultation Paper No. 9/2013-14 dated 21st May 2013 on determination of Aeronautical Tariffs in respect of Rajiv Gandhi International Airport, Shamshabad, Hyderabad for the first control period (01.04.2011 - 31.03.2016)

Dear Madam,

A kind reference is invited to AERA Consultation Paper No. 9/2013-14 dated 21st May 2013 on determination of Aeronautical Tariffs in respect of Rajiv Gandhi International Airport, Shamshabad, Hyderabad for the first control period (01.04.2011 - 31.03.2016).

The comments of Association of Private Airport Operators (APAO) on the various issues highlighted in the AERA Consultation Paper are enclosed herewith for your kind perusal and consideration.

The enclosed comments are framed based on the existing Regulatory framework and we would like to submit that APAO reserves its right to review the stand taken on any of the issues as the Regulatory process evolves.

We look forward to your kind consideration of our submissions on the Consultation paper. We will be more than happy to provide any further information / clarification on the above, if required, by the Authority.

Yours Faithfully,
For Association of Private Airport Operators

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Association of Private Airport Operators (APAO)

Response to AERA's Consultation Paper No. 9/2013-14 dated 21st May 2013 on determination of Aeronautical Tariffs in respect of Rajiv Gandhi International Airport, Shamshabad, Hyderabad for the first control period (01.04.2011 – 31.03.2016)

05 August 2013

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List of Abbreviations

Term	Description
AAI	Airports Authority of India
ACI	Airports Council International
AERA	Airports Economic Regulatory Authority of India
AS	Accounting Standard
ATM	Air Traffic Movements
Capex	Capital Expenditure
CAPM	Capital Asset Pricing Model
Consultation Paper	Consultation paper issued by AERA on Determination of Aeronautical Tariff in respect of Rajiv Gandhi International Airport (HIAL) for the 1st control period
CSIA	Chhatrapati Shivaji International Airport
DEL	Delhi
D/E	Debt Equity
DF	Development Fee
DIAL	Delhi International Airport Private Limited
DGCA	Directorate General of Civil Aviation
FRoR	Fair Rate of Return
ICAI	Institute of Chartered Accountants of India
IDC	Interest during construction
IGI Airport / IGIA	Indira Gandhi International Airport
MIAL	Mumbai International Airport Limited
MoCA	Ministry of Civil Aviation
mppa	million passengers per annum
MYTP	Multi Year Tariff Proposal
NIPFP	National Institute of Public Finance and Policy
NPV	Net Present Value
NTA	Non Transfer Asset
OMDA	Operation, Management and Development Agreement
OSP	Operation Support Period
RAB	Regulatory Asset Base
RoCE	Return on Capital Employed
ROE	Return on Equity
SSA	State Support Agreement
Tariff Guidelines	Terms and Conditions for Determination of Tariff for Airport Operators Guidelines, 2011
TAMP	Tariff Authority of Major Ports
The Act	The Airports Economic Regulatory Authority of India Act, 2008
UDF	User Development Fee
VRS	Voluntary Retirement Scheme
WACC	Weighted Average Cost of Capital
X Factor	Tariff escalation factor
y-o-y	Year on year

1. INTRODUCTION

1.1. Airports Economic Regulatory Authority of India

The Airports Economic Regulatory Authority of India (AERA or the Authority) was established pursuant to the enactment of the Airports Economic Regulatory Authority of India Act, 2008 (the Act), to perform the following functions for major airports:

1. Determine tariff for aeronautical services
2. Determine the amount of the development fee including the User Development Fee (UDF)
3. Determine the Passenger Service Fee (PSF)
4. Monitor the set performance standards relating to the quality, continuity and reliability of service as may be specified by the Government of India or any authority authorized by it in this behalf.

1.2. Stakeholder Consultations

Section 13(4) of the Act states that the Authority shall ensure transparency while exercising its powers and discharging its functions

(a) by holding due consultations with all stake-holders with the airport
(b) by allowing all stake-holders to make their submissions to the Authority; and
(c) by making all decisions of the Authority fully documented and explained

1.3. Issuance of the Consultation Paper for Rajiv Gandhi International Airport, Hyderabad, India

As part of the stakeholder consultation referred to in 1.2 above, the Authority has issued Consultation Paper No.9/2013-14 dated May 21, 2013 (the Consultation Paper) on determination of aeronautical tariffs in respect of Rajiv Gandhi International Airport (RGIA or the Airport), Shamshabad, Hyderabad, India for the first control period April 1, 2011- March 31, 2016. The Authority had sought written evidence-based feedback, comments and suggestions from the stake-holders by July 1, 2013. There were requests for extension of time for submission of comments by the stake-holders at the stakeholder consultation meeting held on June 18, 2013. The Authority, by issuance of Public Notice No.01/2013-14 dated June 24, 2013, extended the last date for submission of comments to July 22, 2013. Subsequently, by issuance of Public Notice No.03/2013-14 dated July 22, 2013, it extended the last date for submission of comments to August 5, 2013.

This submission includes responses to the key issues arising from the Consultation Paper on behalf of the stake-holders represented by the Association of Private Airport Operators (APAO).

2. MACROECONOMIC FACTORS AND ISSUES

2.1. Private Airports in India

The Indian civil aviation industry has witnessed, and continues to witness unprecedented growth. To meet this expanded as well as the anticipated demand, there would be a need for approximately 350-375 operational airports across the country. This implies that significant private investments will have to be attracted as the Airports Authority of India (AAI) alone will not be able to raise the required funds of approximately US $ 30 billion.

The 12th Five Year Plan estimates that almost $15 billion of investments will be needed across airports in India and a significant portion of this investment will be driven by the private sector.

The Government of India has taken number of initiatives to open the airport sector to private sector participation by modernizing existing brownfield airports (Mumbai and Delhi) as well as setting up of new Greenfield airports (Bengaluru, Hyderabad and Kochi) using the PPP model. These five airports have demonstrated that PPPs are successful and preferred models for the development of world class airport infrastructure and facilities in the country.

The total passenger traffic carried through all airports in India in 2012-13 was approximately 159 million. Of this, the five PPP airports constituted almost 60% of the traffic.

2.2. Benefits of Private Airports to Indian Civil Aviation

The PPP airports contribute significantly to India's Gross Domestic Product (GDP) and provide significant employment opportunities. The passengers and cargo shippers have benefited by the provision of world class travel and cargo facilities with improved connectivity. In addition, and most tellingly, the PPP airports contribute significantly towards the development of civil aviation infrastructure by cross-subsidizing AAI's operations and development programme. For FY 2012-13, the AAI's profit before tax was Rs 12.38 billion, whereas the contribution of the five PPP airports by way of revenue share amounted to approximately Rs 21.55 billion. Thus, the entire profit made by AAI for 2012-13 is attributable to the contribution by the five PPP airports. **This demonstrates without doubt that the five PPP airports have enabled AAI to remain financially viable and profitable.** They have enabled AAI to develop other airports in the country. They have also enabled the AAI to offer discounts/rebates on aeronautical charges to the users at some AAI airports. While this is tantamount to funding a competitor and distorting the competition and the level playing field, it also has indisputably contributed to the PPP airports upholding user interests.

The five PPP Airports have not only created world class airport infrastructure facilities in the country, but have also been adjudged by Airports Council International (ACI) as amongst the best airports in the world in their respective categories.

Key awards include:

- Airports Council International awards:
  - New Delhi Indira Gandhi International Airport-for service quality-2nd best airport in the 25-40 million passengers per annum (mppa) category-2011 and 2012
  - Mumbai Chhatrapati Shivaji International Airport-for service quality- 3rd best airport in the 25-40 mppa category- 2011 and 2012
  - Hyderabad Rajiv Gandhi International Airport-for service quality-2nd best airport in the 5-15 mppa category-2012, 3rd best airport-2011 and 1st in 2009 and 2010
  - Bengaluru International Airport- for service quality-3rd best airport in the 15-25 mppa category-

2011.

India's privatized airports have also won numerous other awards such as SKYTRAX World Airport awards, Routes Airport Marketing awards, Asian Annies awards, National Tourism awards etc.

Better airport infrastructure at the PPP airports including Hyderabad has contributed to increased airline revenues and cost savings. Such infrastructure has through effective design and implementation enabled a reduction in the time taken by airlines to service passengers and therefore assisted their efficient and cost effective handling of increased passenger numbers also, better airside infrastructure has led to a significant reduction in turnaround times and thereby enabled a consequential increase in the number of flights handled at the airports. It has also resulted in substantial cost savings for Airlines on account of reduction in fuel costs due to better air traffic management and improved ground infrastructure facilities at these airports.

2.3. Economic Impact of Private Airports

Economic impact of an airport is measured in terms of its contribution to four key economic indicators, namely- (i) Output (ii) Value added (i.e. Gross Domestic Product or GDP) (iii) Employment generated and (iv) Contribution to tax revenues.

The economic impact of private airports can be categorized as follows:

2.3.1 Direct Impact

This is measured in terms of the employment and income arising from the setting up of an airport, its operations and utilization of the services provided at the airport or in the surrounding area

2.3.2 Indirect impact

This is measured in terms of the employment and income generated by other industries in the region where the airport is situated.

2.3.3 Induced impact

This is measured in terms of the employment and income generated in the region where the airport is situated on account of such airport being able to attract new investments and tourism initiatives.

The private airports in India have been instrumental in generating a positive economic impact by virtue of their ability to contribute to increasing passenger throughput, GDP, tax revenues and generation of employment. They have therefore played a pivotal role in the economic growth of the country in general, and to the economic growth of the regions where they are based, in particular.

The National Council of Applied Economic Research [NCAER] conducted an economic impact study in respect of RGIA. The key points arising from this study are as follows:

- RGIA's construction contributed Rs.11.9 billion to the national GDP
- RGIA's construction activities generated approximately 121,700 jobs
- RGIA's direct contribution to Andhra Pradesh's economy in terms of income is estimated to be 0.299% of the Gross State Domestic Product (GSDP) by 2020-21
- RGIA's direct plus indirect (multiplier) income contribution to Andhra Pradesh's economy is estimated to be 0.838% of GSDP by 2020-21.

3. RISKS ASSOCIATED WITH PRIVATIZATION OF AIRPORTS

Privatization of airports carries risks to all the parties involved such as the concessionaire, the lending financial institutions as well as the concerned Government. The concessionaire is exposed to risks arising from the uncertain prospects of achieving an adequate return from the commercial operation of the airport, its ability to increase revenues through capital improvements and facility expansions, and the financial risk on account of the actual capital outlay and financial commitment required at the commencement of the project - often before the airport starts generating any revenues. The lending financial institutions are affected by the risk that the concessionaire may fail to achieve its target operating profits, and thus be unable to repay the debt. The concerned Government carries the risk that the concessionaire may not be able to fulfill the technical and financial commitments made by it for the airport project.

The risks involved in the development and operation of private airports the world over, including India, are similar despite India's strong potential for generation of air traffic. The risk-reward relationship therefore needs to be determined in a manner so as to make it attractive to private sector investors. This in turn would depend upon the approach adopted for economic regulation which, while protecting the interests of the passengers also needs to protect the interests of the airport developers/operators.

Given the intent of the Government of India to attract private and foreign investments to improve infrastructure development in general and civil aviation infrastructure in particular as stated by the PMO in June 2013, the Regulator needs to consider strongly whether the approach to airport charges as proposed is likely to achieve this National objective.

4. SPECIFIC ISSUES RELATED TO RGIA

4.1. Regulatory Till

As per the Consultation Paper, the Authority has sought to determine the aeronautical tariffs in respect of the Airport under Single Till. This recommendation is in accordance with the Order No.13/2010-11 dated January 12, 2011 (the Order) which lays down the regulatory philosophy and approach to the economic regulation of airport operators. The Consultation Paper issued by the Authority has also taken into consideration the following:

(a) Concession agreement contemplated dual till
(b) International Civil Aviation Organization (ICAO) policies on economic regulation
(c) Provisions of the AERA Act, 2008
(d) Ministry of Civil Aviation (MoCA)'s stand on the choice of till
(e) Government of Andhra Pradesh (GoAP) view on the choice of till
(f) Planning Commission view on the choice of till
(g) Airports Council International (ACI) view on the choice of till
(h) UK Competition Commission on the choice of till
(i) European Union on the choice of till

APAO's response outlined below examines the applicability of the Order to RGIA and comments on the conclusions derived by the Authority in the course of its examination of the grounds under 4.1 (a) through (i) above. In addition, it also provides an overview of the global precedents and practices which support RGIA's contention that single till isn't the accepted global norm and that dual and hybrid tills are also considered acceptable approaches globally.

4.1.1 Applicability of the Order and the Single Till Approach to RGIA

<u>Extracts from AERA Order:</u>

4.1.1.1. **Paragraph 5.137 of the Order** states that *"....Single Till is most appropriate for the economic regulation of major airports in India".*

4.1.1.2. **Paragraph 3.4 of the Order** states that *"In respect of Bengaluru Airport (BIAL) and RGI Airport Hyderabad (GHIAL), the article 10 of the respective Concession Agreements prescribe that Regulated Charges, i.e. Airport Charges specified in Schedule 6 of the Concession Agreement, shall be consistent with the ICAO policies".*

4.1.1.3. **Paragraph 3.5 of the Order** states as that *"...Further, the Authority believes that the general framework for economic regulation of aeronautical services as being laid down here is consistent with ICAO policies. Therefore, the framework being laid down here would also be applicable to Bengaluru and Hyderabad airports".*

<u>Extract from the Consultation Paper:</u>

4.1.1.4. **Paragraph 23.32 of the Consultation Paper** states that *"The Authority concludes that ICAO is not favouring any particular form of regulatory till whether single till/dual till".*

4.1.2 APAO Response

APAO submits that it is important that AERA reconsiders its approach of imposition of Single Till, since India could become something of an international outlier, with detrimental effects on its ability to attract major investment. It is clear that ICAO policies encompass the possibility of Dual Till and that one of the grounds that AERA has previously adduced for Single Till does not therefore stand. In these circumstances, AERA needs to reconsider whether Single Till is the most appropriate system for regulation of RGIA. As identified above, Single Till is neither the system most commonly applied to major private international airports, nor that which is most likely to generate the investment that the Indian aviation sector requires.

4.2. Sanctity of the Principles Envisioned in the Concession Agreement

4.2.1 Applicability of the Concession Agreement

4.2.1.1. The Concession Agreement for the development, construction, operation and maintenance of RGIA was entered into between the Ministry of Civil Aviation, Government of India and Hyderabad International Airport Limited (HIAL) on December 20, 2004.

Extracts of the Concession Agreement:

4.2.1.2. Article 10 pertains to charges which could be imposed by RGIA. These could be in the nature of Airport Charges (Article 10.2) and Other Charges (Article 10.3).

4.2.1.3. Article 10.2 states that "the Airport Charges specified in Schedule 6 ("Regulated Charges") shall be consistent with ICAO policies". As per Schedule 6, the Regulated Charges would be landing charges, parking charges, housing charges, Passenger Service Fee and User Development Fee.

4.2.1.4. Article 10.3 states that "HIAL and/or Service Provider Right Holders shall be free without any restriction to determine the charges to be imposed in respect of the facilities and services provided at the Airport or on the Site other than the facilities and services in respect of which Regulated Charges are levied".

Extract of the Consultation Paper:

4.2.1.5. **In paragraph 23.20.5 of the Consultation Paper**, the Authority has stated that *"the Concession Agreement nowhere mentions, for example, that the revenues from the 'other charges' should not be reckoned during the determination of aeronautical tariff"*.

4.2.2 APAO Response

It is evident from Articles 10.2 and 10.3 that the Concession Agreement has clearly defined as to which charges would be regulated and which charges would be free from regulation.

The Authority's view conflicts with the Concession Agreement which clearly bifurcates the regulated and other charges. Bringing the other charges under the ambit of regulation by imposing the Single Till approach goes against the letter and spirit of the Concession Agreement.

As per APAO's understanding, the GoAP has written a letter to the Authority wherein it has clarified that Article 10(3) of the Concession Agreement gives the right to HIAL to set tariffs for non-airport facilities and services and that the concession does not envisage cross subsidy from non-aeronautical revenues to defray aeronautical charges.

4.3. ICAO Policies

4.3.1 Applicability of ICAO Policies

4.3.1.1. ICAO released the Ninth edition of Doc 9082 namely, ICAO's Policies on Charges for Airports and Air Navigation Services, in 2012.

<u>**Extracts of the ICAO's Policies on Charges for Airports and Air Navigation Services:**</u>

4.3.1.2. **Clause 14** of the said document states that *"States* ***should adopt an approach*** *to economic oversight* ***that meets their specific circumstances****. The degree of competition between providers, the costs and benefits of different forms of oversight as well as the legal, institutional and governance frameworks should be taken into consideration when selecting the appropriate approach.* ***Regulatory interventions should be used only when required, and kept to a minimum****".*

4.3.1.3. **Clause 2(i) of Section II-ICAO Policies on Airport Charges** states that *"The cost to be allocated is the full cost of providing the airport and its essential ancillary services, including appropriate amounts for cost of capital and depreciation of assets, as well as the costs of maintenance, operation, management and administration.* ***Consistent with the form of economic oversight adopted****, these costs* ***may be offset*** *by non-aeronautical revenues".*

<u>**Extract of the Consultation Paper:**</u>

4.3.1.4. As stated in 4.1.1.4, in **paragraph 23.32** of the Consultation Paper, the Authority concludes that ICAO is not favouring any particular form of regulatory till whether single till/ dual till".

4.3.2 APAO Response

The ICAO policy does not specifically endorse Single Till regulation and **leaves the choice of till to the member states based on their local conditions and circumstances**. It also states that *costs may be offset* by revenues depending upon the form of economic oversight adopted.

It is APAO's view that it would be essential for the Authority to ensure that the till approach sought to made applicable to RGIA is also in line with the Concession Agreement which does not seek to regulate the 'Other Charges' nor does it contemplate any cross subsidization either from non-airport revenues or from Other Charges as envisaged in concession. In light of this, APAO humbly submits that the Authority's proposition to undertake such cross subsidization is not acceptable.

4.4. AERA Act

4.4.1 Applicability of the AERA Act

<u>**Extracts of the AERA Act:**</u>

4.4.1.1. The preamble of the Airports Economic Regulatory Authority of India Act states that it is "An Act to provide for the establishment of an Airports Economic Regulatory Authority **to regulate tariff and other charges for the aeronautical services** rendered at airports and to monitor performance standards of airports and also to establish appellate tribunal to adjudicate disputes and dispose of appeals and for matters connected therewith and incidental thereto"

4.4.1.2. **Section 13(1)(a) of the Act** states that the Authority shall determine tariff for aeronautical services taking into consideration various factors including revenue received from services other than aeronautical services.

4.4.2 APAO Response

Under Section 13 of the AERA Act, the Authority is statutorily required to consider the concession offered to the airport operators by the Central Government, as well as the other agreements which form an integral and inalienable part of such concession.

Section 13(1)(a)(vi) of the Act requires the Authority to consider the concession granted by the Central Government while determining the tariffs.

The proviso to Section 13(1)(a) of the Act states that *"different tariff structures may be determined for different airports having regard to all or any of the considerations specified at sub-clauses (i) to(vii)"*. In other words, the Act recognizes the flexibility given to AERA to determine tariff structures for different airports having regard to various considerations including the concession granted by the Central Government.

So even though the AERA Act empowers AERA to regulate tariff for Aeronautical Services as defined in Section 2(a) of the AERA Act, in case any concession has already been granted by the Central Government, AERA is required to consider the terms of such concession. This is an exception to the mandate of the Act which is recognized and allowed by the Act itself.

In the case of RGIA, the concession granted by the Central Government states that apart from the 'Regulated Charges', the Airport shall be free without any restriction to determine all Other Charges. This implies that AERA is only empowered to regulate the Regulated Charges as defined in the Concession Agreement.

4.5. Ministry of Civil Aviation and the Government of Andhra Pradesh View on Till

4.5.1 Applicability of MoCA and GoAP View

4.5.1.1. The MoCA has, in the case of Delhi International Airport Limited and Mumbai International Airport Limited, taken into consideration the philosophy specified in the respective State Support Agreements in determining the till applicable to these two airports.

Extract of the State Support Agreement:

4.5.1.2. **Clanse 2.3 (b)(i) of the State Support Agreement** entered into between the GoAP and HIAL on September 30, 2003 refers to the maintenance of an equity internal rate of return of 18.33%.

Extract of the Consultation Paper:

4.5.1.3. The Authority has, **in paragraph 23.63 of the Consultation Paper,** stated that as per the Act, it is required to take into consideration agreements only with the Central Government.

4.5.2 APAO Response

The Authority's contention that, as per the Act, it is required to taken into consideration agreements only with the Central Government is contrary to the MoCA's approach which does take into account the provisions of all associated agreements. The Authority also considered all associated agreements in the course of the tariff fixation of Delhi and Mumbai airports.

APAO is of the view that all agreements associated with the concession should be taken into consideration by the Authority for RGIA too.

The Authority has considered the Interest Free Loan, the Grant, the land given for the airport usage etc. in the State Support Agreement in determining the tariffs for RGIA. It therefore also needs to take into consideration the other critical aspect stated in this agreement, namely, the equity internal rate of return. APAO understands that the equity internal rate of return of 18.33% mentioned in the State Support Agreement is based on the business plan and the financial and feasibility projections in respect of the airports viability submitted to the State Government with the concurrence of the MoCA. The Authority should take this factor into account in determining the till.

4.6. Planning Commission View on Choice of Till

4.6.1 Planning Commission View on Choice of Till

Extract of the Consultation Paper:

4.6.1.1. The Authority has in **paragraph 23.78 of the Consultation Paper** stated that "Incentivizing or attracting private sector investment of an amount may be assigned a meaning that either the private parties should be investing the target amount of money as equity or should arrange for finances from banks and financial institutions in private sector as well as FDI, if any, for this amount".

4.6.2 APAO Response

It is understood that the Planning Commission has written a letter dated October 6, 2010 to the Authority in which it has stated that the choice of economic regulation is an important factor in attracting private sector investment. It has also opposed the Single Till approach.

The private sector would only be willing to invest in the airport sector provided it is incentivized in a manner which is attractive and at the same time affords the user, better air connectivity at an affordable price.

In the 12th Five Year Plan (2012-2017), the Planning Commission has projected an investment of Rs.710 billion for the development of airport infrastructure in the country. Of this, Rs.570 billion is expected to be invested by the private sector. It is therefore imperative that the regulatory framework is investor friendly. A case in point is that though as per the Government's liberalized policy, 100% Foreign Direct Investment (FDI) is allowed for the development of Greenfield airports, the airport sector hasn't managed to attract FDI. This situation underscores the need for a predictable and conducive regulatory environment which creates confidence in, and attracts, investors.

It is particularly important to note this in light of the Prime Minister and Planning Commission Chairman both announcing over Rs. 20,000 Crore investment in airports through PPP mechanisms in June 2013.

In addition, given the 'lumpy' nature of Airport CapEx and investment, it is unusual that the Authority has taken the opaque view in the Consultation Paper as stated in 4.6.1.1 that the meaning implied is that the target amount of money is 'invested as equity'. Globally, airport infrastructure investment has been historically based on funding through debt and equity and the policies followed by Indian operators including HIAL, is no different. There is little to no chance that investors will fund airport investments through a majority equity infusion given typical size of investments, especially of the quantum required in India and particularly on greenfield airport projects. This to us seems a wholly unreasonable and unrealistic assumption by the Authority and one that we believe should be reconsidered.

4.7. UK Competition Commission (CC) View on Choice of Till

4.7.1 Applicability of UK CC View on Choice of Till

4.7.1.1. In determining the regulatory till applicable to Heathrow, Gatwick and Stansted airports, the Competition Commission (CC) in its report issued in 2002 noted that "no useful inferences can be drawn at this time from overseas airports which use the dual till in whole or in part, as their circumstances are different from those of the three BAA London Airports".

4.7.1.2. The CC referred to ICAO's policy that there should be flexibility in applying either the Single Till or Dual Till approach.

4.7.2 APAO Response

Similar to the CC's observation in 4.7.1.1 above, the circumstances in respect of RGIA would be completely different from the three London airports. The setting up of RGIA in particular was unique because it was the first Greenfield airport which was developed using the PPP model. Accordingly, it may not be appropriate to compare the facts and circumstances in respect of India, which belongs to an emerging market, to those of the UK which is in a mature market, in deciding the applicable regulatory approach. For example, the requirements of India for investment are likely to be greater and the risks for investors greater – both factors which should influence the choice of till. It is also notable, as identified above, that the regulatory arrangements in the UK are under review in ways which may place less emphasis on cost based regulation.

4.8. Global Precedents in Respect of Airports Adopting Dual Till

4.8.1 Applicability of Global Precedents of Airports Choice on Till

4.8.1.1. There are precedents where airports in several countries have adopted the Dual Till approach. In such cases, the costs of aeronautical services have been considered in the determination of aeronautical tariffs without offsetting from the revenues from the airport's commercial activities. These countries/airports include:

- Germany- Hamburg and Frankfurt Airports
- Greece- Athens Airport
- Hungary- Budapest Ferihegy Airport
- Italy- Rome, Milan and Venice Airports
- Malta-Malta Valetta Airport
- The Netherlands- Amsterdam Schipol Airport (although we understand that the process is under review and subject to potential change from 2016 onwards)

4.8.2 APAO Response

APAO is strongly of the view that the Dual Till approach, which has found acceptance and application globally amongst regulators, be made applicable to HIAL.

4.9. Regulatory Asset Base (RAB) and Treatment of Land / Real Estate

4.9.1 Applicability of RAB and Treatment of Land / Real Estate

Extract of the Land Lease Agreement:

4.9.1.1. A Land Lease Agreement was entered into between the Government of Andhra Pradesh and HIAL on September 30, 2003. As per this agreement, the term "Airport" means "the Greenfield international airport to be constructed and operated by the lessee at Shamshabad near Hyderabad and includes all buildings, equipments, facilities and systems, **aeronautical and non-aeronautieal** and airport-centric activities and includes without limit, where the circumstances so required, any expansion of the airport from time to time".

4.9.1.2. **Recital E of the Land Lease Agreement** states that *"the Project is feasible only with the State Support of the Lessor….."*.

4.9.1.3. **Recital E of the State Support Agreement** states that ***"the project is feasible only with State Support** (as defined hereinafter) **of GoAP and both GoI and GoAP have agreed and accepted that the implementation of the Project and the operation of the Project and its facilities requires extensive and continued support and actions and grant of certain rights and authorities by GoAP which are prerequisites to the mobilization of resources (including financial resources) by HIAL and performance of HIAL's obligations under the Concession Agreement, and therefore, the GoAP has agreed to provide the State Support to HIAL as set out in this Agreement"***.

Extract of the Consultation Paper:

4.9.1.4. **In paragraph 9.23 of the Consultation Paper**, the Authority has stated that *"any revenues obtained from the commercialization of land in excess of the project requirements are required to be ploughed into the project. The GoAP had also made available State support for the project to make it feasible through the State Support Agreement (ADFG and IFL). It is clear that the Authority had thought of the mechanism to reduce RAB by the market value of such commercial activities generally outside the terminal building (except what clearly are aeronautical services). This, in view of the Authority, would establish the nexus between the purpose of grant of land (to make the project feasible) and lowering the charges on the passengers….According to the Authority's understanding, the disposal of land acquired for a 'public purpose' is normally not given for pure commercial and residential activities unless revenue generated from such activities is utilized for making some other public purpose feasible. In the extant case, therefore, the Authority felt that the revenues from such commercial activities should flow to the airport (public purpose). One of the mechanisms that the Authority had thus contemplated was to reduce the market value from RAB so as to lower the charges on passengers which, in its view, is consistent with the scheme of the grant of lease to HIAL for the project"*.

4.9.2 APAO Response

Recital E of both the Land Lease Agreement and the State Support Agreement clearly outline the fact that the project would be feasible only with provision of State Support in the form of resources (finance, land etc.) to build, own and operate the Airport which includes non-aeronautical activities as stated in 4.9.1.2 and 4.9.1.3 above.

The recommendation of the Authority in the Consultation Paper (stated in 4.9.1.4 above) would go against the spirit of the State Support Agreement and the Land Lease Agreement which lay down that the very purpose of providing the various resources including land was to make the project feasible. The Authority seems to have taken a narrow view of the term 'project' to mean only the airport as opposed to the definition in the Land Lease agreement which defines the project to include aeronautical and non-aeronautical activities as stated in 4.9.1.1 above. Further, it also seems to have considered that financial support in the form of Advance Development Fund Grant (ADFG) and the Interest Free Loan (IFL) combined with use of land only for aeronautical activities would end up making the project feasible. It therefore does not take into consideration the fact that the use of land for non-aeronautical activities was integral to the case for developing the airport and making it financially feasible. We understand that the GoAP has written a letter to the Authority clarifying that the land was given for the socio-economic benefit of the state and that subtracting its market value from the RAB will mean that the desired benefit will not be achieved.

The development of a Greenfield airport is a risky undertaking. It involves the construction of significant infrastructure before even a single plane can fly. There are therefore very high fixed up front costs which are very difficult for an investor to justify. The provision of land for commercial exploitation for the period of the concession was therefore intended to provide the investor with additional sources of revenue to enable returns on the airport project to be sufficient to remunerate the capital employed. Nevertheless, the Operator also has to bear the risks associated with the various businesses forming a part of the non-aeronautical activities. And the land provided for commercial exploitation is not for perpetuity, but for the life of the concession only. The proposed deduction of the market value of such land from the RAB runs counter to the whole purpose for which it was provided. It would mean that it is effectively being used to reduce aeronautical revenues rather than to augment the returns to the Operator from the investment made in the project. By significantly reducing the overall returns to the project, this would reduce returns of the developer/operator and negatively impact its financial viability and in a way that does so retrospectively contrary to natural justice and the principles of good regulation.

In view of the above discussion, it is APAO's view that assigning a value to the land and subtracting the same from the RAB is not consistent with the Concession Agreement.

The treatment proposed by the Authority also gives rise to a question whether by way of a corollary, the market value of land used for the airport business should be added to the RAB for tariff determination.

It is also worth noting that the proposed treatment of non-aeronautical land is neither consistent with the theory of single till, nor with international precedents.

First, in so far as there is an economic rationale for single till, it is that all the revenues attributable to airport-related activities should be taken into account. There is no good reason why this should encompass land and activities outside the airport boundary which do not arise directly from operation of the airport.

Second, to the extent that values and/or revenues are moved into and out of the RAB, account needs to be taken of the totality of the financial flows involved. In this case, that would mean the costs of developing any land, not just the revenues or market value.

Based on a review of the practices at several global airports, it is apparent that real estate is kept outside the regulatory till and not used to cross subsidize airport charges. This practice is followed at the Belgium

(Bruxelles), France (Charles de Gaulle, Orly), Germany (Frankfurt, Hamburg), Italy (Rome, Milan and Venice), Australia (Adelaide, Brisbane, Melbourne, Perth and Sydney) and New Zealand (Auckland, Christchurch and Wellington) airports.

In short, AERA's proposal is in principle inconsistent with the agreements on which the airport's development was based and investment attracted (representing a substantial retrospective adjustment to those terms) and is in practice inconsistent with regulatory best practice. Non-airport related activities should not feature in the single till and to the extent adjustments to the till are made, they need to take account of all the financial flows involved.

4.10. Cost of Equity Calculation

4.10.1 Applicability of CoE Calculation

Extract of the Consultation Paper:

The Authority has proposed:

4.10.1.1. To calculate asset beta for RGI Airport, Hyderabad based on the comparable airports as per the report by NIPFP and thus proposes to consider asset beta for RGI Airport, Hyderabad at 0.51 as an upper bound since this does not discount for the various risk mitigating measure

4.10.1.2. To re-lever the asset beta of HIAL at the notional Debt-Equity Ratio of 1.5:1

4.10.1.3. To calculate equity beta according to CAPM framework

4.10.1.4. To consider Return on Equity (post tax Cost of Equity) as 16% for the Weighted Average Cost of Capital (WACC) calculation – both under single till and dual till

4.10.1.5. To consider a nominal risk free rate of 7.35% (as against 7.7% proposed by HIAL)

4.10.1.6. To calculate the nominal cost of capital based on the historic rates of return on Government debt

4.10.1.7. To consider the asset beta for RGIA at 0.51 (as against 0.75 proposed by HIAL)

4.10.1.8. To consider an equity risk premium of 6.71% (as against 11% proposed by HIAL)

4.10.2 APAO Response

In determining the CoE, the Authority needs to pay regard to the outcome it wishes to incentivize, in particular, the availability of investment in a fast growing aviation sector. The losses to consumers from delay in capacity being brought on stream due to lack of investment, and resulting higher fares charged by airlines, are likely to outweigh shorter term benefits from keeping the cost of equity too low.

Against this background, it is crucial that the CoE provides an assurance to current – and prospective - investors that returns on their investment are commensurate with the risks they have borne. The absence of adequate returns risks disincentivizing investment as investors pursue more remunerative opportunities both in India and more widely. The importance of this dimension is underlined by the potential for (and lack of success so far in attracting) FDI to Indian airports. The regulator's judgment needs to take full account of this need to attract investment into the sector. This is not so much an issue of balancing investor interests against those of passengers but more of balancing the short term interests of passengers in low prices against their longer term interests in enhanced capacity and connectivity in a situation where high rates of growth means that the longer term is actually not that far into the future. It is also submitted that as against the returns to equity investors in the power sector which are allowed on the equity infused, in the airports sector such return is allowed on the RAB. Since the RAB depreciates over the concession period, this means that the effective returns are lower for the operator. The CoE allowed by the regulator therefore needs to compensate the operator to make up for the lower returns by allowing a suitably higher CoE.

Determination of the Cost of Equity

Determining the cost of equity for regulatory purposes entails using available data, including but not restricted to historic data, to make judgments about the forward looking cost of equity. The best approach to this will likely vary according to the different components of CAPM. In some cases, greater weight may be placed on historic data, in others more weight on current data. In the case of the risk free rate, it appears to APAO that too much weight has been placed on historic data. The nominal risk free rate may be thought of as comprising two components:

- The underlying real rate of return
- An inflation rate

The NIPFP approach rests on the historic performance of the overall nominal rate as represented by the return on Government debt. However, such unadjusted historic debt rates will be most relevant to measuring future risk free rates when future conditions are anticipated to be very similar to those in the past. This is unlikely to be the case given the significant fluctuations in rates of inflation in India during the past decade. The table showing the Wholesale Price Index (WPI) inflation for the years 2006 through 2012 is given below:

Year	WPI inflation %
2006	4.50%
2007	6.90%
2008	5.20%
2009	9.40%
2010	4.80%
2011	12.50%
2012	12.80%

Source: *Reserve Bank of India*

This effectively means that the returns which an operator would make would be substantially/totally wiped out on account of inflation. In effect, the real risk free rate would be negative.

Against this background, the Authority might be better advised to use historic data to determine the underlying real interest rate, but to pay more attention to more recent inflation performance in determining the inflation rate to be incorporated into the nominal figure. To do otherwise risks setting a risk free rate below (potentially significantly so) that which should obtain going forward.

Betas

It is apparent from the National Institute of Public Finance and Policy (NIPFP) report relied upon by the Authority, that there are significant variations in airport betas. This therefore necessitates focusing on those comparators which are likely to be more realistic and attaching less weight to outlying observations that cannot be adequately explained.

In APAO's view, instead of considering a simple average of an arbitrary list, appropriate weightage should have been assigned to each of the comparators based on the degree of their comparability.

It may be worthwhile to note that NIPFP itself has commented on the difficulty in determining the comparator set as stated below:

"Since the private airport business in general, and these new mega-airports (like DIAL) in particular are relatively new, and AERA has a unique regulatory approach……it is not possible to say at this stage which subset of airport companies would be the best comparators….As we come to understand more, it could be reasonable to take a bottom-up approach to constructing the beta, or take a smaller sample of comparable airport companies. In our view, at this stage, neither of these approaches is feasible".

(Source: Page 15 of the 'Cost of Equity for Private Airports in India-Comments on DIAL's response to AERA Consultation Paper No.32, and the report by SBI Caps' issued by the NIPFP Research Team on April 19, 2012)

The NIPFP has acknowledged in a way that the comparator set used may not be the best or adequate for determination of beta. However, it has not explored any alternative comparator set (such as the one proposed by HIAL) and instead sought to hastily conclude that taking a bottom-up approach or using a different sample of comparator companies is not feasible.

The Cost of Equity estimates computed by various leading consulting firms are given below:

Sr No	Name of Consultant	Cost of Equity
1	Crisil Infrastructure Advisory	18.16-20.44%
2	KPMG India Private Limited	20-25%
3	SBI Capital Markets Limited	18.5%-20.5%
4	Jacobs Consultancy	24%

As can be seen, the Cost of Equity estimates determined by NIPFP (13.2%) and the Authority (16%) are much lower than those arrived by the various consulting firms.

APAO stands by the comparator set used by HIAL and urges the Authority to consider the same for determining the beta in case of HIAL.

Given India's state of economic development, airports in emerging markets should be an important reference point. This is because their betas are likely to be impacted by broadly similar factors, such as significantly higher rates of economic growth and income elasticity of demand than in more mature markets, both of which would tend to increase the susceptibility of airport revenue and profitability to economic fluctuation. APAO therefore wishes to state the 'sense check' argument that the betas for Indian airports cannot be lower than those of airports in mature markets and should tend to be higher. One argument used by NIPFP against focusing on emerging market betas is that this might give too great a weight to Chinese airports. While in principle this might be an issue, the practical fact is that no group of airport betas is precisely comparable and it seems likely that one that gives greater weight to emerging markets is likely to be more comparable than one which attaches significant weight to airports in developed countries with more mature aviation sectors. While the NIPFP approach appears to be more balanced by including a wider range of different airports, in practice, it is not because inclusion of that wider range is likely systematically to bias the results and in a way that is at variance with economic commonsense, the observations from markets such as Thailand, Mexico and Malaysia as well as China and produces a result which means that airports are judged less risky than many other forms of utility.

Also, the upper bound of the beta considered by the Authority for Kolkata and Chennai Airports in the Orders for tariff determination for the first control period 2011-2016 for these airports is 0.61. Both the Kolkata and the Chennai airports are owned and operated by the Government. The risk element attributable to these airports may well be lower compared to privatized airports. Therefore, it is inconceivable that the asset beta for both airports is higher than that proposed by the Authority for RGIA (0.51) where the risk borne by the private sector operator would be significant not least given that it is a greenfield project.

The Authority seems to have sought to overplay the role of the mitigants such as the User Development Fee (UDF) to cover shortfall in revenues, granting monopoly for a certain area etc. This is evident from NIPFP's rather weak conclusion on the subject of beta which is reproduced below:

"We accept the argument that it is possible that typically the macro-economic shocks would be likely to be strongly transmitted to the airport sector in a period of high traffic growth, but it is not clear to what extent this can be expected to happen in India's airports, given the mitigants in place and the revenue sources. It is possible that the beta estimates we have arrived should be sufficient to cover for such risks"

(Source: Page 17 of the 'Cost of Equity for Private Airports in India-Comments on DIAL's response to AERA Consultation Paper No.32, and the report by SBI Caps' issued by the NIPFP Research Team on April 19, 2012)

In APAO's view, this is an insufficiently firm conclusion on which to base a regulatory judgment on cost of equity. The choice of the beta should give more than a 'possibility' that risks are covered. A regulator needs to be assured that on the balance of evidence the beta is, in an inevitably uncertain world, the right number. NIPFP's conclusion does not give that assurance. This point is underscored by consideration of the individual mitigants on which it purports to rely.

APAO's view is that the UDF was granted to cover the shortfall of revenues during the process of tariff determination. Given the quantum of investment, this was the very least investors would expect.

The grant of monopoly to an airport seeks to insulate it against competition by not allowing an airport to be set up within a specified radius (e.g.150 kms) for a specified period (e.g.25 years) from the date of the opening of the airport. This is thought to reduce the beta relative to comparators which do not have this grant. However, a casual inspection of the list of airports provided by NIFPF suggests that most have de-facto as much of a 'monopoly' as RGIA. In such circumstances, the grant of a monopoly is not a distinguishing factor reducing the risk of the airport relative to realistic comparators. The mention in the NIPFP report of the London market is inaccurate because, while the three airports are now in separate ownership, the betas referred to in the reports were based on a period when BAA indeed held a monopoly.

In view of the above discussions, APAO wishes to submit that the beta estimate relied upon by the Authority is flawed and that the beta of 0.75 originally proposed by HIAL be considered in determining its CoE.

Equity Risk Premium

The NIPFP paper relies solely on the work of Professor Damodaran in its derivation of the equity risk premium.

In evaluating risk premia for individual countries, Professor Damodaran advocates the adoption of an approach which is based on using the equity risk premium for a well-established mature economy market (for example the United States) and adjusting for relative country risk.

While Professor Damodaran mentions other methodologies, his preferred approach used the following formula:

Country Equity Risk Premium = Country default spread X standard deviation equity/standard deviation bond.

In practice, however, NIPFP's estimate of 6.71% does not follow the preferred Damodaran methodology. It instead uses a lower value for the mature market risk premium based on one assessment of US historic figures and adds a default spread of 2.4% which is not factored up by relative volatility (as specified in Damodaran's preferred methodology). The resulting estimates are nearly two percentage points lower than the result of 8.6% endorsed by Damodaran himself.

In comparison, the equity risk premium proposed by HIAL of 11% was based on the research paper ***"A First Cut Estimate of the Equity Risk Premium in India"*** by **Prof. Jayanth R.Varma and Prof. S.K. Barua** which gave a range of the equity risk premium as being between 8.75% and 12.51%. The results were supported by **Prof. Rajnish Mehra**, who reports a risk premium between 1991 and 2004 of 9.7%.

Based on the above discussion, APAO requests the Authority to reconsider the risk-premium to the originally proposed equity risk premium of 11%.

Re-levering and Delevering

For re-levering the asset beta, NIPFP has relied upon a report published by the Bank of America – Merill Lynch.

APAO submits that the report relied upon by NIPFP should be reconsidered due to the following factors:

- The analyst seems to have estimated a probable regulatory outcome to determine the market value leading to circularity in the approach adopted
- Estimates of market value of equity by analysts can have a wide range, and are unlikely to serve as a reliable basis for tariff estimation.

4.11. Others

4.11.1. Forex Loss Adjustment

4.11.1.1. In the tariff model submitted by HIAL, under the heading capital expenditure, it has included a foreign exchange loss adjustment arising on account of gains/losses due to the External Commercial Borrowing (ECB) loan as a part of the RAB. HIAL has submitted that the adjustment has been computed as per Accounting Standard 11.

4.11.1.2. HIAL borrowed US Dollar 125 million [i.e. Rs.5.07 billion at an exchange rate of Rs.40.56] by way of External Commercial Borrowing (ECB) from Abu Dhabi Commercial Bank. If the exchange rate of Rs.54.30 considered by the Authority in determining the tariff for the current control period were to be applied to the ECB as well, an additional amount of Rs.1.72 billion arising from the foreign exchange fluctuation [(Rs.54.30-Rs.40.56) x US Dollar 125 million] would have to be included in the ECB value considered for the determination of WACC. However, since the Authority has sought to not consider the foreign exchange difference in the determination of tariff for aeronautical services, it would lead to a loss of Rs.0.98 billion for HIAL for the control period.

Extract of the Consultation Paper:

4.11.1.3. Paragraph 9.40 of the Consultation Paper:

"The Authority understands that sourcing of funds is a conscious business decision of the airport operator. Thus, the Authority proposes not to consider any adjustments related to foreign exchange variations in its determination of tariff for aeronautical services and accordingly proposes to disallow the amounts considered by HIAL under the head "Forex Loss Adjustment as per AS11" as well as from ECB Loan facility".

4.11.1.4. **APAO response:**

APAO submits that the Authority should allow the foreign exchange variations as a pass through cost in its determination of tariff for aeronautical services on account of the following reasons:

- HIAL chose to borrow funds by way of ECB due to the cheaper borrowing cost. **It has passed on the entire benefit arising on such saving to the end user and as such the associated risk also needs to be passed on to the end user.** If HIAL had chosen to borrow by way of a domestic loan, there would have been an additional cash outflow of approximately Rs.211 million per annum on account of interest costs [arrived at by considering a differential interest rate of 4.17% [11.85% on Rupee Loan – 7.68% on ECB Loan] on a borrowing of Rs.5.07 billion.
- The foreign exchange loss is not notional, but an actual loss
- The borrowing was finalized prior to AERA's proposition of disallowing the forex loss adjustment in the Consultation Paper. Hence, there is no way that this borrowing can be reversed by Airport Operator.
- The foreign exchange loss would adversely impact HIAL's profitability.

4.11.2. Quality of Service rebate

4.11.2.1. The Authority proposes to adopt a mechanism to consider reduced tariffs for under-performance vis-à-vis specified benchmarks on the quality of service to adequately protect the interest of users. Under such a mechanism, the calculated level of rebate for a year will be passed on to users of airport services in the form of reduced tariffs in the following year(s).

4.11.2.2. The Authority proposes to implement the rebate scheme from 4^{th} tariff year of the current control period i.e. 2014-15. Rebate for the year 2014-15 would be carried out in 2016-17, which is the first tariff year of the next control period.

4.11.2.3. **APAO response:**

APAO wishes to submit that Clause 9.2 of the Concession Agreement in respect of 'Monitoring of Performance Standards' lays down the performance standards and penalties for not conforming to the standards. We believe these provisions are stringent and provide an adequate deterrent in case of the operator's non-compliance. Therefore, the imposition of additional penalties by the Authority would result in doubling the jeopardy for the operator. APAO therefore requests the Authority to reconsider its decision of imposing a rebate mechanism as it would impose additional onerous penalties on the operator for the same default.

The operations of any airport involve participation of various external agencies for air traffic control, security etc. Hence, the efficient functioning of an airport is also dependent upon such agencies. These agencies are independent and not under the control and supervision of the airport operator. Therefore, it may be inappropriate to penalize the airport operator alone for service quality discrepancies as some of such discrepancies may have occurred due to factors which are completely beyond the operator's control.

Several private airports in India have been adjudged as the best airports in the world in their respective categories. It may therefore be appropriate for the Authority to consider a mechanism which recognizes awards and incentivizes superlative performance by airports.

5. CONCLUSIONS

- **Benefits of privatization:** Privatization of airports has undoubtedly changed the face of the Indian airport sector. The five PPP Airports in India have not only created world class airport infrastructure facilities in the country, but have also been adjudged by Airports Council International (ACI) as the best airports in the world in their respective categories. They have also created a beneficial economic impact by significantly contributing to GDP and tax revenues and also generating employment. They have also contributed significantly towards the development of civil aviation infrastructure by cross-subsidizing AAI's operations and development programme thereby directly upholding the user interests.

- **Risks to operators involved in privatization:** The risk-reward relationship needs to be determined in a manner so as to make it attractive to private sector investors. This in turn would depend upon the approach adopted for economic regulation which, while protecting the interests of the passengers also needs to protect the interests of the airport developers/operators.

- **Regulatory approach:** APAO strongly contends that the Single Till approach should not be made applicable to HIAL owing to the following reasons:

    - The Single Till approach conflicts with the Concession Agreement which have bifurcated the charges into regulated and other charges and there is no express provision related to cross subsidization in the Concession Agreement.
    - The scope of the legislative mechanism i.e. the AERA Act mandates Authority to consider concession agreement wherein a Dual Till is envisaged.
    - The equity internal rate of return of 18.33% mentioned in the State Support Agreement would have been based on the financial projections in respect of the airports viability submitted to the State Government and signed off at the time of the Business Plan / Feasibility Projections with the concurrence of the MoCA and the State Governments. The Authority should take this as the minimum IRR.
    - The Authority's contention that as per the Act, it is required to taken into consideration agreements only with the Central Government is contrary to the MoCA's approach which does take into account all associated agreements as well.
    - It is understood that the Planning Commission has written a letter dated October 6, 2010 to the Authority in which it has stated that the choice of economic regulation is an important factor in attracting private sector investment. It also has opposed the Single Till approach.
    - The EU Directive leaves it to the Member State to decide the till approach to be adopted and whether or not and to what extent the revenues from an airport's commercial activities may be taken into account in establishing airport charges
    - Global precedents available indicate that the Dual Till approach, which has found acceptance and application globally amongst regulators, be made applicable to HIAL.

- **Regulatory Asset Base and treatment of land/real estate:** The recommendation of the Authority in the Consultation Paper that any revenues obtained from the commercialization of land in excess of the project requirements are required to be ploughed into the project would go against the spirit of the State Support Agreement and the Land Lease Agreement which lay down that the very purpose of providing the various resources including land was to make the project feasible.

  The Authority seems to have taken a narrow view of the term 'project' to mean only the airport as opposed to the definition in the Land Lease agreement which defines the airport to include airport and non-airport activities.

  Further, it also seems to have considered that financial support in the form of Advance Development Fund Grant (ADFG) and the Interest Free Loan (IFL) combined with use of land only for aeronautical activities would end up making the project feasible. The development of a Greenfield airport is a risky undertaking. It involves the construction of significant infrastructure before even a single plane can fly. There are therefore very high fixed up front costs which are very difficult for an investor to justify. The provision of land for commercial exploitation for the period of the concession was therefore intended to provide the investor with an incentive to invest in project. Nevertheless, the Operator also has to bear the risks associated with the various businesses forming a part of the non-aeronautical activities.

The proposed deduction of the market value of such land from the RAB runs counter to the whole purpose for which it was provided. It would mean that it is effectively being used to reduce aeronautical revenues rather than to augment the returns to the Operator from the investment made in the project. By significantly reducing the overall returns to the project, this would reduce returns of the developer/operator and negatively impact its financial viability and in a way that does so retrospectively contrary to natural justice and the principles of good regulation. Hence, it does not take into consideration the fact that the use of land for non-aeronautical activities was integral to the developing the airport and making it financially feasible. Therefore, assigning a value to the land reducing the same from the RAB is not in consonance with the Concession Agreement. It also goes against the intended purpose of the Land Lease Agreement and would significantly affect the feasibility of the non-airport activity component of the Airport.

- **Cost of equity:**
  - It is crucial that the CoE provides an assurance to the investors that returns on their investment would be commensurate with the risks they have borne. This is not so much an issue of balancing investor interests against those of passengers, but more of balancing the short term interests of passengers in low prices against their longer term interests in enhanced capacity and connectivity in a situation where high rates of growth means that the longer term is actually not that far into the future. In addition, the cross-subsidization of AAI's operations enhances passenger interests significantly and the investment in aviation at the private airports including RGIA has gone a long way in developing aviation infrastructure across the nation. As against the returns to equity investors in the power sector which are allowed on the equity infused, in the airports sector such return is allowed on the RAB. Since the RAB depreciates over the concession period, this means that the effective returns are lower for the operator. The CoE allowed by the regulator therefore needs to compensate the operator to make up for the lower returns by allowing a suitably higher CoE.
  - **Risk free rate:** CoE should be based on establishing a forward looking rate for the expected return on Government debt which would be used as a notional risk free rate. The nominal risk free rate should take into account:
    - The underlying real rate of return
    - An inflation rate which takes full account of recent experience
  - **Beta:** APAO stands by the comparator set used by HIAL and urges the Authority to consider the same for determining the beta in case of HIAL. It also wishes to submit that the beta estimate relied upon by the Authority is flawed and that the beta of 0.75 originally proposed by HIAL be considered in determining its CoE.
  - **Equity Risk Premium:** APAO requests the Authority to reconsider the risk premium to the originally proposed equity risk premium of 11%.
  - **Relevering and delevering asset beta:** APAO submits that the report relied upon by NIPFP should be reconsidered due to the following factors:

- The analyst seems to have estimated a probable regulatory outcome to determine the market value leading to circularity in the approach adopted
- Estimates of market value of equity by analysts can have a wide range, and are unlikely to serve as a reliable basis for tariff estimation

- **Forex Loss Adjustment:** HIAL borrowed a sum of US Dollar 125 million by way of ECB. This borrowing was finalized prior to AERA's proposition of disallowing the forex loss adjustment in the Consultation Paper. Hence, there is no way that this borrowing can be reversed by Airport Operator.

  The entire benefit associated with this borrowing has been passed on to the end user and as such, the associated risk also needs to be passed on to the end user.

  Since the Authority has sought to not consider the foreign exchange difference in the determination of tariff for aeronautical services, it would lead to a loss of Rs.0.98 billion for HIAL for the control period. APAO submits that the Authority should allow the foreign exchange variations as a pass through cost owing to the following reasons:

  - HIAL chose to borrow funds by way of ECB due to the cheaper borrowing cost. **It has passed on the entire benefit arising on such saving to the end user.**
  - The foreign exchange loss is not notional, but an actual loss
  - The foreign exchange loss would adversely impact HIAL's profitability.

- **Quality of Service rebate:** The Authority proposes to adopt a mechanism to consider reduced tariffs for under-performance vis-à-vis specified benchmarks on the quality of service to adequately protect the interest of users. Under such a mechanism, the calculated level of rebate for a year will be passed on to users of airport services in the form of reduced tariffs in the following year(s).

  APAO wishes to submit that provisions in respect of performance standards in the Concession Agreement are stringent and provide an adequate deterrent in case of the operator's non-compliance.

  Imposition of additional penalties by the Authority would result in doubling the jeopardy for the operator. APAO therefore requests the Authority to reconsider its decision of imposing a rebate mechanism as it would impose additional onerous penalties on the operator for the same default. APAO also wishes to submit that the operations of any airport involve participation of various external agencies for air traffic control, security etc. which are independent and not under the control and supervision of the airport operator. Therefore, it may be inappropriate to penalize the airport operator alone for service quality discrepancies as some of such discrepancies may have occurred due to factors which are completely beyond the operator's control. Several private airports in India have been adjudged as the best airports in the world in their respective categories. It may therefore be appropriate for the Authority to consider a mechanism which recognizes awards and incentivizes superlative performance by airports.

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