ASSOCIATION OF PRIVATE AIRPORTS OPERATORS

Association of Private Airport Operators (APAO)

Response to AERA's Consultation Paper No. 16/ 2014-15 dated 28th Jan 2015 on determination of Aeronautical Tariffs in respect of Indira Gandhi International Airport, Delhi for the Second Control Period (01.04.2014 – 31.03.2019)

13th March 2015

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1) About APAO

Association of Private Airport Operators (APAO) is an apex Industry Association of the Major Private Airports in India. It was founded in 2009, APAO is a non-profit organization registered under the Societies Act, 1860 with the prime objective of promoting the growth and development of the privatized airports to truly world class standards.

2) **Overall Principles**

AERA has published its 'Consultation Paper No. 16/2014-15 on Determination of Aeronautical Tariffs in respect of Indira Gandhi International Airport, Delhi for the Second Control Period (01.04.2014 – 31.03.2019) on 28th January, 2015.

We appreciate the Authority for a detailed and elaborate analysis laid out in its consultation paper. We welcome the steps taken by the Authority to invite comments and suggestions from the stakeholders on the tariff proposals and hereby present our comments in the following sections.

We request the Authority to favorably consider our submissions while finalizing the tariff Order of Indira Gandhi International Airport, Delhi.

It is noted from the current proposals in the CP that, DIAL will face significant challenges to meet its financial obligations, maintain service quality standards and even meet the routine expenditure. It is observed that the Authority has disregarded its basic responsibility to take into consideration economic and viable operation of major airports while determining the tariff for aeronautical services.

Moreover, the current proposals, where the Authority has re-opened its own earlier orders, are against the Project Agreements and will shake the confidence of private investors.This will further scare them away from the next phase of privatization in the country. The exacerbated regulatory risk will pose a major hindrance to the existing and prospective investors.

With respect to various proposals, we submit our detailed response to the above CP as follows:

3) Economic Viability

<u>AERA is mandated to ensure economic viability of DIAL</u>

At the outset, APAO respectfully states that the CP will put question marks on the very survival of the airport (i.e. DIAL). AERA act mandates AERA (Authority) to ensure economic viability of the Airports under Section 13 (1) (a) of the AERA Act. It reads as follows:

"to determine the tariff for the Aeronautical services taking into consideration: (iv) economic and viable operation of major airports"

Authority in its various consultations leading to current tariff methodology has laid down that it will ensure:

1. Economic viability of airports
2. Make the investment attractive
3. There will be ability to pay dividend
4. There will be appreciation in value of investment

The following is the analysis of consultation paper i.e. Consultation Paper No. 3/2009-10 dated 26th February, 2010 on Regulatory Philosophy and Approach in Economic Regulation of Airports and Air Navigation Services (which had same provisions as in White paper no. 01 /2009-10 dated 22nd December, 2009 on Regulatory Objectives and Philosophy in Economic Regulation of Airports and Air Navigation Services).

In para 3.3 (Page 15) of the consultation paper no.03/ 2009-10 dated 26th February, 2010, following has been laid down under Regulatory Objectives & Principles :

3.3 It is worthwhile here to bring out again that the Act was enacted to achieve the following objectives:

> *"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."

As such what was envisaged was an Efficient Airport having Economic and Viable Operations. Para 3.3 (page 15) of the consultation paper reiterates the mandate under AERA Act as under:

The Act provides for the Authority to take into consideration the following factors while determining tariffs for aeronautical services in respect of major airports:

*(a) The capital expenditure incurred and **timely investment** in **improvement of airport facilities**;*

*(b) The **service provided**, its **quality and other relevant factors**;*

*(c) The cost for **improving efficiency**;*

*(d) **Economic and viable operation** of major airports;*

*(e) **Revenue received from services other than aeronautical services**;*

*(f) The **concession offered** by the Central Government in any agreement or memorandum of understanding or otherwise;*

(g) Any other factor that may be relevant for the purposes of the Act.

As such Authority while fixing tariff was to ensure

1. economic and viable operation of airport and
2. adherence to concession agreement:

*A*uthority had mentioned that it wanted to maintain investor confidence in following manner:

3.7 The Authority will operationalise these broader regulatory objectives through the following three key parameters:

a) Viable operations of airports in terms of maintaining investor confidence of a fair rate of return on 'net investment'[2] in those airports. For this purpose it will attempt to incentivise efficient airport investment and operations while ensuring their fair remuneration.

b) *Specification of a framework and qualitative and quantitative parameters to ensure that the quality of service provided at airports while determining tariffs is consistent with the net investment in those airports and the user expectations.*

c) *Ensuring efficiency, adequacy and consistency in provision of air navigation services by encouraging efficient and appropriate investment through a fair rate of return.*

As such it was envisaged that Authority will ensure that investor confidence is maintained by allowing a fair rate of return. As regards to WACC authority had laid down as under:

A. Weighted Average Cost of Capital

3.9 In simple terms, the cost of capital represents the level of return investors require to make investments viable. Given the available sources of finance the cost of capital, generally, represents a combination of:

- *The interest paid on debt in the form of banks loans, bonds and other lending mechanisms; <u>and</u>*
- *<u>an expectation of a return on equity, invested in the business, to investors in return for an expectation of dividend payments and an expectation of an increase in the value of the shares</u>.*

As such what was envisaged was a return which leads to dividends and increase in value of shares.

The concession agreement of DIAL (SSA page 3) also lays down as under:

(E) "In consideration of the JVC having entered into OMDA and to enhance the smooth functioning and viability of the JVC, in addition to the obligations of the AAI under the OMDA, the GOI is agreeable to provide some support to the JVC. "

As such it is clear that AERA Act and also the concession agreement mandates AERA to ensure economic viability. This needs to be ensured by the Authority while determining aeronautical tariffs.

However the current consultation paper lays down as under:

Table 41: Authority's computation of Equity to be considered towards WACC in respect of DIAL in the second Control Period

In Crore	FY2014-15	FY2015-16	FY2016-17	FY2017-18	FY2018-19
Paid-up Equity					
Opening Paid-Up Equity	2,300.00	2,300.00	2,300.00	2,300.00	2,300.00
Additions to Paid-Up Equity	-	-	-	-	-
Closing Paid Up Equity	2,300.00	2,300.00	2,300.00	2,300.00	2,300.00
Reserves and Surplus to be considered towards equity					
Reserves and Surplus brought forward	(969.86)	(909.21)	(1,601.88)	(2,178.14)	(2,682.78)
Profit for the Year appropriated to Reserves and Surplus	60.65	(692.67)	(576.26)	(504.64)	(379.08)
Reserves and Surplus carried forward	(909.21)	(1,601.88)	(2,178.14)	(2,682.78)	(3,061.86)
Reserves and Surplus to be considered towards equity	-	-	-	-	-
Equity considered for calculation of WACC	2,300.00	2,300.00	2,300.00	2,300.00	2,300.00

The above table shows that DIAL's reserve and surplus (based on AERA's opex and non-aero numbers which are practically difficult to achieve) will be (-) 3062 Crores. As such:

1. AERA Act's mandate that economic viability will be achieved is being violated
2. The provision of concession agreement to ensure economic viability is being violated.
3. Investor confidence is shaken as entire net worth of company is getting eroded.
4. There will be no dividend to the investor even after 10 years of investment.
5. There will be no appreciation of amount invested.

This raises the very basic question as to why investor should invest in airports in India.

APAO Recommendation:

It is thus important that the overarching regulatory approach should be to ensure economic viability of DIAL. While there are areas that Ministry of Civil Aviation can look into to ensure economic viability of airport, the responsibility cannot be passed on to MoCA while at the same time the Authority takes positions which aggravate economic unviability. It is earnestly requested that all the decisions of Authority are thoroughly reviewed to ensure economic viability of airports.

4) Violation of Concession: Cargo Screening treated as Non Aero

AERA has proposed to consider Cargo Screening income as Aeronautical

AERA has laid down certain proposals which are in violation of the concession agreement. One of such proposal is regarding classification of Cargo Screening Income as aeronautical in nature. It is absolutely clear from the Schedule 6 of the OMDA that any income accruing on account of cargo related activities is non-aeronautical in nature.

SCHEDULE 6
NON-AERONAUTICAL SERVICES

"Non-Aeronautical Services" shall mean the following facilities and services (including Part I and Part II):

Part I

1. Aircraft cleaning services
2. Airline Lounges
3. Cargo handling
4. Cargo terminals

i. APAO, in principle, is of the view that there should be no violation of concession agreements and the entire tariff fixation should be as per provisions of concession agreement.

ii. Subject to above principle being adhered, APAO would like to highlight that AERA had considered Cargo Screening as Non Aero while calculating the Hypothetical RAB. If AERA decides to consider Cargo Screening revenues as aero then retrospective effect should be given by adding the cargo screening income in FY2008- 09 in the aeronautical income to be reckoned towards calculating Hypothetical RAB.

iii. Additionally, Ministry of Civil Aviation had confirmed in a communication to AERA that any revenues from cargo related business should be classified under non aeronautical head. The relevant extract from the said letter is shown as below:

2. This Ministry had already, in the context of IGI Airport, Delhi, clarified to AERA vide letter dated 9.3.2012 that revenues from Cargo and Ground Handling services accruing to the airport operator should be categorized as non-aeronautical

iv. The new proposed Ground Handling Policy as issued on 28th Sep, 2007 vide AIC Sl. No. 7/2007 by DGCA defines ground handling to include:

1.1. "Ground handling" means:

i. ramp handling which shall include the activities specified in Annexure 'A';

ii. traffic handling which shall include the activities as specified in Annexure 'B'; and

iii. any other activity specified by the Central Government to be a part of either ramp handling or traffic handling.

The passenger handling items are given in Annexure B of the aforesaid policy. It includes amongst others the X-Ray scan of cargo (para5.1):

5. Security

5.1 Registered baggage X-ray scan check (baggage and cargo)

5.2 Surveillance/vigilance for registered baggage at baggage make-up/break-up area of the airport

5.3 Baggage identification / watch and ward of registered baggage

As such the cargo screening is part of ground handling and as such it need to be treated as Non-Aeronautical.

It seems that treatment of cargo screening as aero by AERA is stemming from the notion that cargo screening is security service. AERA may note that as per the new GH policy X-Ray in any nature whether baggage/ cargo/ aircraft are classified as Ground Handling Services, which is considered non aeronautical in nature.

APAO recommendation:

In view of the provisions of concession agreement and based on evidence produced above, the Cargo screening be considered as Non-Aeronautical for the tariff determination of DIAL.

Annexure: Enclosed is the new ground handling policy

5) Violation of Concession: Revenue Share as a Pass through for Tax Building Block

AERA has proposed to consider Revenue Share as a pass through and treat as operating cost for Aero Tax Calculations

AERA has laid down one more proposal which is in violation of the concession agreement. AERA has proposed to consider Revenue Share as a pass through and treat it as operating cost for Aero Tax Calculations while it is not considering the Revenue Share as pass through while determining aeronautical tariffs.

The treatment of revenue share as an operating expense is against the State Support Agreement. The Section 3.1.1 of the agreement clearly states:

"the Annual Fee paid/payable by the JVC to AAI under the OMDA shall not be included as part of the costs for the provision of Aeronautical Services and no pass through would be available in relation to the same"

Furthermore, the treatment by AERA with respect to revenue share is extremely discretionary and inconsistent. The proposal penalizes the airport twice, once by not including revenue share as a part of building block and another by treating it as a pass through for arriving at aero tax building block.

i. In compliance with the provisions of SSA, the target revenue of the DIAL is calculated as per the following formula:

The revenue target is defined as follows

$$TR_i = RB_i \, x \, WACC_i + OM_i + D_i + T_i - S_i$$

Where T=Tax represents the corporate taxes on earnings only **on Aeronautical Services**

ii. AERA may note that regulatory and statutory accounts are two different set of books. Regulators in other parts of the world do not follow statutory accounts. Both are considered to be separate set of books of accounts. They only regulate on a notional entity which includes all or part of some parts of revenues or cost but exclude others.

i) In Denmark, as in many countries it is possible for some assets in the statutory accounts to be revalued – particularly when they have a market value which can be directly assessed.
ii) For Copenhagen Airport, these revaluations are included in statutory accounts but excluded in accounts used for regulatory purposes.

APAO Recommendation:

Hence, it is recommended that tax should be allowed in the regulatory accounts based upon the calculation in which Revenue Share is not taken into account as an expense which is in accordance with the example and provisions of the SSA.

6) **Cute Counter charges considered as Aeronautical revenue**

1. Cute counter is only the rental income of counters.
2. ICAO's Policies on Charges for Airports and Air Navigation Services, appendix 3- Glossary of Terms defines Revenues from non aeronautical sources as:

"*Any revenues received by an airport in consideration for the various commercial arrangements it makes in relation to the granting of concessions, the rental or leasing of premises and land and free zone operations, even though such arrangements may in fact apply to activities that may themselves be considered to be of an aeronautical character (for example, the concessions granted to oil companies to supply aviation fuel and lubricants and the rental of terminal building space or premises to aircraft operators)*".

Since, Cute counter charges are in nature of rental income, they should be considered as Non Aeronautical charge.

7) Deviation from issues already finalized in first control period

There are several instances where Authority has changed its own /principles/ decisions taken in earlier orders, some of which are:

1. Change in methodology of reduction of DF from RAB.
2. Change in classification of revenues such as Into Plane and Cargo Screening which are classified as Aeronautical while earlier they were classified as Non Aeronautical.
3. Change in treatment of DF interest as capex whereas it was classified as Opex.
4. Change in methodology for allocation of airport operator fee.
5. Truing up of Other Income which was not envisaged in first control period.

Some of major issues in this regard are discussed below:

In most common form, regulatory Risk is defined as the risk of or having conditions applied retrospectively and reviewing its own stands which adversely impacts the economic value of an enterprise. As a result of reviewing'/changing its own principles/decisions, the regulatory risk in the airport regulatory environment will exacerbate substantially.

India is placed at 142 among 189 countries in the latest World Bank's 'Ease of Doing Business' report released in Sep 2014.The regulator should move in tandem with the business friendly philosophy of the Govt. of India.

A regulatory uncertainty is the last thing that an investor will want. This uncertainty will lead to:

1. **Investor Interest:** Investor shying away from investing in country. This is clearly reflected in case of the bidding of Navi Mumbai project which saw only 4 investors at RFQ stage.
2. **Lenders :** The existing airport lenders will not be able to recover their investment in the company leading to weakening of financial system
3. **Quality:** The quality standard at airport cannot be maintained. Delhi airport has been ranked first in ASQ ratings in 25-40 million capacity airports. This great feat will go waste and

Indian airports will return to their old pathetic stage which had warranted the current privatization.

4. **Safety:** If the net worth of airport is getting eroded, it will mean that airport is not able to generate sufficient funds to ensure safety of airport. This can have dangerous consequences, if the airport starts cutting corners in an overzealous attempt to avoid the costs, especially those related to safety.
5. **Economy:** the airport is a catalyst of economic development of the region. If airport is not able to function well because of regulatory risks and uncertainties, this will hamper the economic development associated with airports as well. New privatized airport also have resulted in lower turnaround time and no hovering time leading to great saving in precious fuel and greater utilization of resources (aircraft) leading to lower costs.
6. **Support to the development of other airports:** The revenue share being paid by DIAL helps AAI in making investment in other airports which otherwise are not viable. This process may be hampered if DIAL is not able to survive the regulatory risk and resultant loss.
7. **Impact on airline and passengers:** for the first time in country the private airports have ensured capacity ahead of demand. this has resulted in :
    a. airlines expanding without any constraints
    b. Airlines saving huge money due to lower turnaround time and lower wastages due to no hovering time
    c. Passenger getting world class infrastructure at reasonable price as the lower turnaround time of aircraft means lower cost.

All of this will be reversed if the airport is not able to survive.

i. Change in methodology of allowing return on RAB and methodology of adjusting DF from RAB

AERA has proposed to consider changed methodology for adjusting DF and return on RAB

DF is proposed to be reduced from the RAB in the year the securitized loan was borrowed against it.

The reduction of DF from the RAB was done in the year of capitalization and was approved by the AERA in the Order for 1st Control period. Now, the AERA has reopened the whole issue and reduced the DF from the RAB in the year of borrowing instead of year of capitalization which is not as per the principles.

AERA proposes to change the principle of RAB determination (DF adjustment) which was finalised and approved by itself earlier in the 1st control period order. Changing this principle leads to change in tariff for 1st control period which is inconsistent with the provisions of AERA Act, 2008.

In the 1st control period, AERA has allowed the principle of reducing the DF as and when the asset is capitalized in the DIAL's books. This is a more robust methodology and easy to understand and implement. A sudden change in the already allowed building block leads to uncertainty.

Rationale for DIAL reducing DF from RAB during 2010-11 for money borrowed in 2009-10 was that there was no major capitalization of asset during this intervening period. As such the DF adjustment was warranted only when the asset was capitalized.

APAO Recommendation:

The earlier principle of reducing RAB based on year of capitalization of DF assets be restored.

ii. Change in treatment of DF interest as capex

AERA has proposed to consider interest on DF as capex

Interest on DF has been reduced from the 1st control period Operating Cost building block, and it has been added to the RAB. Approx. INR 188 crores were taken off in the 2009-10 2010-11 and 2011-12 which was allowed as a part of operating cost building block. The removal from opex and addition to RAB means that in short run DIAL will face cash problem.

The regulator in the 1st control period allowed the DF interest upto June 2011 as a part of Operating Expense,

Now the Authority has changed its stand and wants to treat this as Capex.

APAO Recommendation:

There should not be any change in treatment compared to what was approved in first control period. Internationally regulatory accounts and statutory accounts are kept separate as treatment of various items in regulatory is many a times different from statutory accounts. In the case of DIAL the Hypothetical Asset Base is part of RAB in regulatory and not part of the statutory accounts. There is no need for regulatory accounts to follow statutory accounts as the two are prepared on different principles.

iii. Allocation ratio of Airport Operator Fee

AERA has proposed to consider Airport Operator Fee as a proportion of aeronautical revenue

i. Airport operator fee being paid by DIAL is at 3% of Gross revenue of Airport. Accordingly AERA now feels it appropriate to treat it as a proportion of aero revenues instead of the methodology used and finalized in the 1st control period, wherein Airport operator Fee was apportioned between Aeronautical and non-aeronautical cost in the weighted average ratio of 87.54% It is important to note that primary role and responsibility of Airport Operator is to ensure smooth and efficient operations of the Airport and their role in management and development of non aero revenues is very minimal and therefore apportion of the cost based upon revenues would be completely incorrect.

ii. Worldwide there is no instance of any opex being allocated based on revenue.

APAO Recommendation:

APAO is of the opinion that allocation as applied to other operating expenses represents the true and fair treatment of the operator fee as well. This is in line with the internationally accepted practice of allocation which is never done on basis of revenue.

iv. **Provision for Bad Debts not allowed as opex**

AERA proposes to disallow Provision for Bad Debts not allowed in both control periods

1. Bad debts are inseparable incident of every business including the airport business. They are a business reality and no business can function without facing bad debts. If bad debts are not reimbursed, effectively, the airport will be forced to pay out of its returns towards bad debts. It is never in the interest of any company to accrue bad debts, however, in every industry bad debts arise as a normal course of the business, default made by Kingfisher Airlines to cite an example.
2. When debts turn bad or become irrecoverable, the provisioning comes in handy to avert unanticipated contingencies. Needless to state that, should bad debts be actually recovered or written off, the provisioning will be reversed.
3. We are of the view bad debts should be allowed as a part of operating expense since it is considered as a part of building block in power sector. Few examples to cite as below:

i) Gujarat Electricity Regulatory Commission has allowed bad debt of 0.067% of ARR.

ii) Chhattisgarh Electricity Regulatory Commission has allowed provision for bad debts subject to actual writing off of bad and doubtful debts.

iii) Madhya Pradesh Electricity Regulatory Commission has allowed bad debts of Rs. 1 crore each for its three distribution companies for FY 2013-14.

iv) Maharashtra Electricity Regulatory Commission allows 1.5% of ARR.

APAO Recommendation:

APAO views bad debts as a legitimate business expense. It would be fair and prudent to allow provision of bad debts at actual. This is in line with similar practice in other regulatory sectors.

v. Other Income used to cross subsidize

AERA proposes to consider Other Income as Non Aero and true up for the first control period despite order on contrary.

i. AERA has revisited its own order no.3/ 2012-13 wherein other income was not used for cross subsidization. In the Consultation paper, AERA now proposes to consider, revenues arising out of Sale of Other Materials / Scrap – Others, Profit on sale of Depreciable Assets, Management Fees, Miscellaneous Income Others and Tender Cost recovery, as non-aeronautical revenue of the airport and cross subsidize towards ARR for the 1st Control Period.

ii. AERA may note that as per the Schedule 1 of the SSA which defines the principles of tariff fixation shows cross subsidization towards non aero revenues as follows:

> S = 30% of the gross revenue generated by the JVC from the Revenue Share Assets. The costs in relation to such revenue shall not be included while calculating Aeronautical Charges.
>
> "**Revenue Share Assets**" shall mean (a) Non-Aeronautical Assets; and (b) assets required for provision of aeronautical related services arising at the Airport and not considered in revenues from Non-Aeronautical Assets (e.g. Public admission fee etc.)

iii. APAO would like to highlight that other income does not fall into the Revenue Share Assets. Hence, any cross subsidization towards other income is against the SSA.

APAO Recommendation:

1. Other income was not part of cross subsidization in first control period and any stand to contrary tantamount to a change in principle and is best avoided.
2. Other Income does not accrue from Revenue Share Assets as per the provisions of SSA and as such is not part of Non Aeronautical income which is to be used for cross subsidization.

As such this should not be used for cross subsidization

vi. Into Plane treated as Aeronautical

AERA has proposed to consider Into Plane as Aeronautical: Was treated as Non Aero in first control period.

i. AERA has mentioned that as per the letter from the Ministry of Civil Aviation, the revenues from Cargo / Ground handling were to be considered as non-aeronautical regardless and irrespective of whether these services are provided by the airport operator himself or concessionaire. Taking a nod from the letter, AERA mentions that if the differentiation of provision of this service by the airport operator himself or by a concessionaire (including JV) appointed by the airport operator were to be disregarded, the revenue from ITP services in the hands of DIAL should be treated as aeronautical revenue.

ii. APAO highlights the fact that AERA has yet again used discretion in classifying ITP and cargo screening as aero. In the same letter AV.24032/04/2012-AD dated 10.09,2012, any income from cargo is to be considered as non aero. The relevant extract is as follow:

"This Ministry had already, in the context of IGI Airport, Delhi, clarified to AERA vide letter dated 9.3.2012 that revenues from Cargo and Ground Handling services accruing to the airport operator should be categorized as non-aeronautical revenues as provided under the OMDA.

APAO Recommendation:

APAO would request Authority to consider into plane as non-aeronautical considering the fact that DIAL is getting only a concession fee for allowing Concessionaires to provide services within the Airport and DIAL is not providing any service to anyone in this regard. This Concession fee is similar to what airport operator receives from flight caterers or ground handlers for allowing them to provide services to customers including airlines within airport premises. ICAO's Policies on Charges for Airports and Air Navigation Services, appendix 3-Glossary of Terms defines Revenues from non aeronautical sources as referred above in earlier paragraph is most relevant in this case as well.

vii. **Interest on Development Fee: partially capitalized whereas it was earlier allowed as opex**

AERA has disallowed interest on Development Fee as operating cost and capitalized in the books

i. As per Decision No. 16 of its Delhi Tariff Order No. 3/2012-13, the AERA had decided to expense out the interest on DF Loan for the entire period of 01.03.2009 to 30.11.2011 as operating expenditure.
ii. Now in the Consultation Paper in discussion, AERA proposes to allow Interest on Development Fee to the extent it is charged to the Profit and Loss on the ground that any interest post the commencement of operations of the terminal 3 is to be expensed out as per the treatment done in the books of accounts.
iii. AERA may note that as discussed previously that regulatory and statutory accounts are two separate books of account. Allowed in one regulatory accounts may be disallowed in the statutory accounts and vice versa.

APAO Recommendation:

APAO suggests that AERA may please consider the order no.3 sacrosanct and should not alter the principles already settled.

8) Asset Allocation: Use of old ratio

AERA proposes to reject the consideration of new asset allocation ratio

i. AERA had considered an asset allocation ratio of 89.25% and 10.75% towards aeronautical and non-aeronautical categories respectively as on 31st March 2011 based on Jacob's Report for the 1st Control Period. The ratio was estimated since it was based on the CAD Drawings and not on the actual area utilized by the concessionaires.

ii. It is critical to point out that DIAL had appointed the same consultant, Leigh Fisher (formerly Jacobs) to revise the asset allocation of terminals based on the actual area leased out to the concessionaire. Furthermore, an auditor certificate to that effect has been furnished to AERA.

iii. As mentioned earlier, the ratio used in the 1st control period was estimated since at that time Terminal 3, the biggest terminal of DIAL, was not in operation at the time of determining the asset allocation ratio. Hence AERA is requested to consider the actual asset allocation ratio for the period in consideration, which is much more logical to consider and a rational extension to the estimated allocation that was used in the first control period. APAO believes there is enough evidence produced before AERA that it may decide to consider the new asset allocation ratio based on the realistic situation.

APAO Recommendation:

As such it is recommended that the new allocation ratio based on actual area occupied be used for tariff determination.

9) Forex Fluctuation: Not allowed

AERA has proposed to disallow Forex fluctuations associated with Foreign Currency Borrowings

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

   i) By resorting to the cheaper source of finance i.e. External Commercial Borrowing, DIAL has passed on the benefit to the airlines and passengers as a result of lower cost of debt. But foreign currency depreciation, which is an external factor beyond the control of the company, has resulted in the increase in the actual cash outflow from the books of the company.

   ii) The External commercial borrowing facility was availed by DIAL before the AERA came into existence. AERA may note that altering the capital structure is a very cumbersome exercise.

   iii) APAO highlights that the capital asset created from the funds sourced via foreign currency loan is subject to depreciation year on year. On the other hand, foreign currency depreciation results in actual increase in the liabilities. ICAI provides the resolution to this under Chapter 46A of AS -11 which provides:

   "In respect of accounting periods commencing on or after the 1st April, 2011, for an enterprise which had earlier exercised the option under paragraph 46 and at the option of any other enterprise (such option to be irrevocable and to be applied to all such foreign currency monetary items), the exchange differences arising on reporting of long term foreign currency monetary items at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, in so far as they relate to the acquisition of a depreciable capital asset, can be added to or deducted from the cost of the asset and shall be depreciated over the balance life of the asset…"

   This treatment was further validated by Ministry of Corporate Affairs by a notification in 2012.

iv) APAO would like to highlight that DIAL's intent to avail Foreign Currency Loan was to reduce the burden on the passenger. But as a result of external factors, it has resulted into actual loss to the company. As a matter of fair treatment, any associated gain or loss should be transferred to the passengers. Non-consideration of the same may result into a situation where existing and future private airports would not subscribe to cheaper source of finance and instead use Rupee Term Loan which is much more expensive source of finance.

v) APAO will also like to highlight that DIAL has not taken out costly exchange hedges as it has relied upon natural hedge derived from its own foreign exchange revenues. This is in line with international best practices and also helps to reduce the cost of hedging that would have otherwise been allowed to pass through to determine aero charges. However AERA has disallowed the Forex fluctuation related to foreign exchange borrowing but on the other hand the gains being made by DIAL due to foreign exchange fluctuation like that of higher UDF revenue, higher revenue of duty free due to Forex fluctuation are being considered as part of tariff determination. This puts DIAL in a double jeopardy and is totally unfair as the addl. cost associated with Forex fluctuation are being burdened on DIAL whereas the natural hedge are being taken away. It is these kinds of irrational decisions that aggravate the viability of DIAL.

APAO Recommendation:

Airport operators who have borrowed in form of foreign exchange linked loan, the Forex fluctuation should be allowed as part of RAB.

10) True up of Non Aero not allowed

<u>AERA has proposed not to true up non aero revenues in the 1st Control Period</u>

i. In the 1st Control period, AERA had decided not to take non aeronautical revenues under the ambit of True Up. This decision of AERA was unilateral and lacked any rational justification.

ii. DIAL is penalized for not achieving very high non aero revenues projected by AERA for FY2013 and FY2014. At the same time, to make a matter worse, non-aero revenues have not been considered for True Up as considered in other airports including Mumbai, Bengaluru, Hyderabad, Lucknow etc.

iii. AERA has mentioned that its purpose of not explicitly providing for true-up of non-aeronautical revenue during the first Control Period was based on the premise that the model adopted by DIAL through JVC route was to increase the non-aeronautical revenue accruing to DIAL, which would have allowed DIAL to keep the upside.

1) APAO submits that many of the other airport operators in country have outsourced the non-aeronautical part of the business. The returns accruing to DIAL in terms of revenue share and lease rentals are similar to what accrues to the other airports. The only difference is that DIAL has a share in the equity of the JVCs. This was done to ensure an efficient control of the operations and provide strategic inputs to help them to achieve long term competence. Using this as a plea for non-true up of non-aero seems unreasonable on AERA's part.
2) Furthermore, APAO notes that despite putting extensive efforts to increase the non-aeronautical revenues in the 1st Control Period, it still has not been able to match the projections considered by AERA for FY2013 and FY2014. Excessively high projections led to unrealistic targets to be met by DIAL
3) In the 1st Control Period, Non aero revenues were forecasted on the following basis:
   a. "The non-aeronautical revenues for various revenue heads for 2008-09 to be considered as the base figure for forecasting the non-aeronautical revenues for FY 2009-10 and 2010-11, escalated by the historical passenger/ cargo growth rates plus a certain %age

increase due to higher penetration as may be applicable (as proposed by DIAL) for those years"

b. "For 2011-12 to 2013-14, the base value of revenue arrived for 2010-11 to be projected based on the traffic growth plus a certain %age year on year increase due to penetration as per DIAL's estimate.

On the basis of the above-mentioned approaches, the Authority arrived at the following numbers for non-aeronautical revenue

Year/ Rs in crores	Non Aeronautical Revenues under Scenario 1	Non Aeronautical Revenues under Scenario 2	Non Aeronautical Revenues under Scenario 3
2009-10	605	605	495
2010-11	599	599	687
2011-12	708	726	835
2012-13	772	810	986
2013-14	832	904	1146

The Authority has considered highest numbers from the above table for determination of tariff for IGI Airport. The rationale mentioned by the Authority in using the above methodology is -

"In line with the universally accepted principle that airports should strive to generate higher non-aeronautical revenue and DIAL„s own objective of obtaining higher revenues through ―concession under Joint Venture with the airport operator, it will only be fair if the higher of the figures in the above tables are used for present tariff determination purposes...."

The approach as considered in Scenario 3 using higher forecasted non aeronautical revenue numbers instead of actual available data is not provided in the SSA. Schedule 1 of SSA defines revenue target as:

$$TRi = RBi \times WACCi + OMi + Di + Ti - Si \ ,$$

where "S= 30% of the gross revenue generated by the JVC from the Revenue Share Assets. The costs in relation to such revenue shall not be included while calculating Aeronautical Charges"

a) As per Schedule 1 of SSA, 30% of the gross revenue generated should be utilized for calculating target revenue. **It does not state that higher non aeronautical revenue should be considered**. APAO propose to utilize actual non aeronautical revenue for financial year 2010 and 2011.

APAO Recommendation:

In our view putting unachievable targets and also not truing up such revenue leads to making airport unviable. With the current proposal entire net worth of DIAL will stand eroded. As such it is requested that a reasonable approach be followed and the non-aero revenue be trued up because it was highly unrealistic growth which was projected earlier by the Authority itself.

11) Operating Expenses Forecast

<u>AERA proposes to allow unreasonably low growth in the Operating Expenses</u>

i. The Authority has proposed 5.2% year on year growth in Aeronautical Operating Expenses for the second control period

ii. The projections are unjustifiably low. The proposed growth in Operating expenses is almost half of the actual inflation witnessed during the 1st control period at 10.13%, year on year inflation during the 1st Control Period is as follows:

Year	Inflation Rate
2010	11.80
2011	10.28
2012	8.42
2013	10.43
2014	9.71
Average	10.13

iii. APAO believes that various terminals like T1C, T1A and T2 etc. are very old terminals which were considered for repair and overhaul. AERA may note that the shelf life of these refurbishments is short and requires considerable amount of repair and maintenance to keep them in operation.

iv. As covered in the Para 17.80 of the CP, where AERA has commented on the true up of operating cost, it has said that

"The Authority notes that the operation and maintenance cost for FY 2013-14 comes to Rs. 584.80 crore, which is an increase of 9.88% over FY 2012-13. Considering that the inflation in FY 2013-14 was 9.50% the real increase in operating expenses from FY 2012-13 to FY 2013-14 works out to less than 1%. Thus the Authority considers the actual operating costs for FY 2013-14 as reasonable and appropriate as the base for projection of operating costs for the second Control Period"

APAO Recommendation:

APAO is of opinion that AERA may consider the projection as filed by DIAL. This could provide some respite for DIAL in meeting the increased operating cost in the 2nd Control Period.

12) True Up of Operating Cost

AERA proposes to True up Operating Expenses based on Actuals: entire saving in opex taken away.

i. DIAL is being penalized for being efficient by clawing back the extra entitlement allowed towards operating cost building block in the order no.3/ 2012-13. The approach promotes inefficiency and may set a precedent for other airports, who may follow loose cost control system and spend more in the last few years of the control period.

ii. APAO recognizes that a fundamental aspect of the CPI-X process is that airports are encouraged to improve performance by receiving the short term benefits for doing so. To the extent that airports outperform target set, the ultimate benefits will be felt by users in the form of reduced costs in years following the next regulatory review, when the gains are incorporated in the regulatory cost base.

APAO Recommendation:

Under CPI-X, the saving in opex for one control period is retained by the Airport while users benefit by way of reduced base cost for next control period. As such the proposed methodology is in violation of concession agreement.

13) Allocation ratio of Operating Expenses

<u>AERA proposes to consider the old allocation ratio for arriving at the aeronautical portion of the Operating Expenses</u>

i. In the Consultation Paper, AERA has noted that DIAL has not provided the reasons for change in allocations of individual heads in the operating cost and as a result it has not considered the new allocation ratio.

ii. AERA may notice that DIAL has submitted the new operating cost allocation ratio based on the same underlying principles which were used to determine the operating allocation ratio for the 1st Control Period. This was further certified by the statutory auditors.

APAO Recommendation:

APAO feels there is enough evidence produced before AERA that it may consider the actual ratio based on the realistic circumstances. There is strong rationale to rely on the new numbers duly certified by the auditors, provided to AERA.

14) **Base Airport Charges**

Authority should have allowed 10% increase in Base airport charges as provided in Schedule 6 to the SSA. Clause 2 of Schedule 6 to the SSA which reads as follows:

"*From the commencement of the 4th year after the effective date and for every year thereafter for the remainder of the term, Authority will set the Aeronautical charges in accordance with clause 3.1.1 read with Schedule 1 appended to SSA, subject always to the condition that at the least , a permitted nominal increase of 10% of the base airport charge will be available to the JVC for the purposes of calculating aeronautical charges in any year after the commencement of the fourth year and for the remainder of the term.*"

15) Treatment Of Revenue From Land Monetisation

Treatment of Land Monetisation towards cross subsidizing the target revenue and allowing return on such funds used for airport business.

The Authority has requested AAI and MoCA to provide their considered view on mechanism for land monetization by DIAL in future and the formulation for treatment of revenue generated by DIAL from monetization of land earmarked for commercial development

However, the position in this respect is very clear from SSA and revenue from such monetization is not to be used for cross subsidizing the target revenue and there is no provision for using the funds mobilised from land monetization in airport business. If such funds are used for airport business, a return equivalent to atleast return on debt should be allowed, if not the return on equity.

As per SSA, only 30% of the gross revenue generated by the JVC from the Revenue Share Assets would be considered for cross-subsidization. Revenue share assets means Non Aeronautical assets which are further, defined in OMDA as all assets required or necessary for the performance of Non-Aeronautical Services at the Airport as listed in Part I of Schedule 6 and all assets required or necessary for the performance of Non-Aeronautical Services at the Airport as listed in Part II of Schedule 6 hereof as located at the Airport, to the extent such assets (a) are located within or form part of any terminal building; (b) are conjoined to any other Aeronautical Assets, asset included in paragraph (i) above and such assets are incapable of independent access and independent existence; or (c) are predominantly servicing/ catering any terminal complex/cargo complex. Therefore it means that Revenue proceeds from any Non Transfer asset is outside the purview of regulation by AERA.

The Authority on one hand expects the operator to use such funds in airport business but on the other hand, does not want to give the operator market linked return on such funds. The Authority also needs to factor in the requirement of funds that would arise when the security deposit is to be refunded as per the agreed terms. It is important to note that the Authority has already discussed and deliberated on this issue in detail while finalizing tariff order for first control period and had taken decisions in accordance with the provisions of SSA and therefore the Authority should not review its own decision.

16) Return of Equity (RoE) of 16% considered by AERA is grossly inadequate

APAO would like to point out that Cost of equity proposed at 16% by AERA, is too low in the context of emerging country airports operating in conditions where retail inflation is currently 7.31% (having previously been higher) and the current 10 year interest rate on Government debt is 8.5%.

A number of consultants have estimated significantly higher costs of capital. This is not surprising given Indian inflation rates and the risks associated with investing in Indian infrastructure. Cost of equity of 16% as determined by CERC, leads to effective cost of equity much more than 16%, reflecting the fact that the notional equity is not depreciated while it is depreciated in case of airports.

Cost of Equity as estimated by Consultants are way higher than cost of equity of 16% as proposed by AERA.

We believe that the cost of equity proposed by AERA at 16% is too low and would make airport businesses non-viable. Low rate of return shall act as a deterrent and discourage the flow of investments towards privatisation of airports.

Central Regulatory Electricity Commission (CERC), adopts a methodology based on return on equity approach with a pass through of interest cost – where as result, the building blocks do not include a return on RAB component. Cost of equity for Airport sector of 16% is perceived to be equal to the Power sector, where cost of equity is applied on equity that is not depreciated while it is depreciated in case of airports. In case of airports, cost of equity is a component for arriving at Weighted Average Cost of Capital (WACC) which is applied on Regulatory Asset Base (RAB) which gets reduced year on year with depreciation.

Comparative analysis of IRR for power and airport sector projects

Assumptions	
Depreciation Rate	7%
Equity Investment	1000
Return on Equity	16%

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**	**12**	**13**	**14**	**15**	**16**	**17**	**18**	**19**	**20**	**21**	**22**	**23**	**24**	**25**
Power Sector																									
Return on Equity	1000	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160
Cash flow - Equity	**-1000**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**	**160**
IRR - Power Sector	**15.5%**																								
Airport Sector																									
Closing RAB	1000	1000	930	860	790	720	650	580	510	440	370	300	230	160	90	20	0	0	0	0	0	0	0	0	0
Return on Equity	0	160	149	138	126	115	104	93	82	70	59	48	37	26	14	3.2	0	0	0	0	0	0	0	0	0
Cash flow - Equity	**-1000**	**160**	**149**	**138**	**126**	**115**	**104**	**93**	**82**	**70**	**59**	**48**	**37**	**26**	**14**	**3.2**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
IRR - Airport Secto	**4.0%**																								

17) **Treatment of Security Deposits**

Authority has decided not to give return over the Security Deposits

APAO's views –

a. Opportunity cost associated with security deposits

There is an opportunity cost associated with Security Deposits (SD) as the SD utilized to fund the capex is expected to have risk inherent to that associated with equity. SD has an opportunity cost and should be treated on par with equity.

SBI Caps in its report to the Government for cost of SD has mentioned as under: *"…….On the quasi-equity for the airport sector, the study has concluded that the rate of return would depend on the type and feature of the instrument being used for such form of finance. The report further states that in quasi-equity, the risk / return profile lies above that of debt and below that of equity……"*

Long-term SDs are similar to loans and/or equity (as applicable) and therefore any asset developed with such funds must be included in the RAB as per applicable Till Mechanism.

b. Lenders treatment of SD as quasi-equity

Lenders have treated SD as quasi-equity, while determining Debt-Equity (DE) ratio for pricing the debt.

c. Precedent from other infrastructure sectors

There are examples from other infrastructure sectors as well, where regulator provides return on the capital employed by the Concessionaire and does not consider the means or source of funding while calculating tariff.

Petroleum sector:

i) Petroleum and Natural Gas Regulatory Board allows a return on 'interest-free security deposits' available with the concessionaire.

ii) The rate of return available on capital employed is 14%. This return along with 70: 30 DE effectively makes it almost 25% RoE.

iii) Moreover, it provides a uniform return on all kinds of capital employed, including deposits. Deposits are not reduced from the capital employed for determination of tariff.

Ports sector:

i) Similarly Tariff Authority for Major Ports (TAMP), the regulator for major ports, offers a uniform rate of return on all kind of capital employed including Net Working Capital, which would include amounts collected through deposits.

ii) Uniform return of 16% is provided on the entire capital employed.

Recommendation:

Security deposits used to finance aeronautical infrastructure, should be provided a return equivalent to equity, or in the worst case, equivalent to a rate between debt and equity.

18) **Working Capital Interest**

Working capital interest should be allowed by AERA since the same is required to fund the day to day operations of the airport and is required in normal course of business. Working capital interest is also allowed by other regulators such as in Power sector.

19) Conclusion

IGI airport has done the country proud by being adjudged the best airport in world (ASQ rating 2014, 25-40 million capacity).

The regulation should encourage the world's best airport developers to invest in India's airports. Tariff regulation should have a balanced approach for both investment environment and passengers' interest. The tariff determination should be consistent with the provisions of concession agreement. Departure from a signed contract will have an adverse impact on new investments in airport projects.

The current tariff determination by AERA will lead to the net-worth of DIAL being eroded, As such it is earnestly requested that AERA must ensure economic viability of airport by:

1 **Adequate Return**: Providing adequate return on investment to ensure that the net worth of airport remains positive. The return should also be allowed on RAB arrived at after the latest allocation ratio.

2 **Full return on investment**: Provide full return on capital invested irrespective of source of funding as being done in other sectors. The return should be allowed on genuine business outflows like Forex fluctuation on foreign exchange borrowing etc.

3 **Classification of revenue:** Classifying revenues as given in concession and as decided in first control period (Cargo Screening, Cute Counter Charges, Into Plane be considered as Non-Aeronautical).

4 **Opex:** Providing adequate opex to ensure that airport can be run in an efficient manner. Also not to disallow genuine business expenditure such as bad debts. The allocation of opex also be based on latest audited numbers.

5 **Non Aero:** Providing achievable non Aeronautical forecast.

6 **CPI-X:** Follow proper CPI-X methodology in calculation of tariff. Calculate tax building block as envisaged in concession agreement.

7 **Avoid uncertainty** amongst regulatory periods: Change in stand amongst regulatory periods is uncalled for both for lenders and investors. This will lead to poor and expensive infrastructure to end users which need to be avoided.

The private airports in country have done the country proud and AERA need to ensure that this good work is carried forward.

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