Association of Private Airport Operators (APAO)

Response to AERA Consultation paper No.14/2013-14 on Determination of tariffs for Aeronautical Services in respect of Bengaluru International Airport, Bengaluru, for the first Control Period (01.04.2011 to 31.03.2016)

19 September 2013

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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 Bengaluru International Airport, Bengaluru, India

As part of the stakeholder consultation referred to in 1.2 above, the Authority has issued Consultation Paper No.14/2013-14 dated June 26, 2013 (the Consultation Paper) on determination of aeronautical tariffs in respect of Bengaluru International Airport (BIA or the Airport), Bengaluru, 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 August 5, 2013. The Authority, by issuance of Public Notice No.4/2013-14 dated August 2, 2013, extended the last date for submission of comments to August 19, 2013. Further, the Authority, by issuance of Public Notice No.6/2013-14 dated August 19, 2013, extended the last date for submission of comments to September 19, 2013.

This Report 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 airport infrastructure 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 2012-13, the AAI's profit before tax for 2012-13 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 of AAI airports. While this is tantamount to funding a competitor and distorting the competition and the level playing field, it also has directly 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 Bengaluru 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. 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 cost savings on account of reduction in fuel costs due to better air traffic management and improved ground infrastructure 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.

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 users also needs to protect the interests of the airport developers/operators.

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

4. SPECIFIC ISSUES RELATED TO BIA

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) Planning Commission view on the choice of till

APAO's response outlined below examines the applicability of the Order to BIA and comments on the conclusions derived by the Authority in the course of its examination of the grounds under 4.1 (a) through (d) above. In addition, it also provides an overview of the global precedents and practices which support BIA'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 BIA

<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 26.139 of the Consultation Paper** states that *"the Authority has made calculations based on both Single and Dual Till and taking into account the totality of circumstances, would finally propose its regulatory approach for stakeholders consultation, noting however that as stated by BIAL, ICAO has no firm policy on the till and hence it cannot be said that it is against either Single Till or 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 BIA. As identified above, Single Till is neither the system most commonly applied to major 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 BIA was entered into between the Ministry of Civil Aviation, Government of India and Bangalore International Airport Limited (BIAL) on July 5, 2004.*

<u>Extracts of the Concession Agreement:</u>

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

4.2.1.3. ***Article 10.2.1 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 "BIAL 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".***

4.2.1.5. ***Article 5.4.3 states that** "in recognition of the investment to be made by the shareholders, from time to time, of BIAL and the Lenders and subject to material compliance by such shareholders and the Lenders with all Applicable Law, **GoI will not take any steps or action in contradiction of this Agreement which results in or would result in such shareholders or the Lenders being deprived or substantially deprived of their investment or economic interest in the Project…". .***

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

4.2.1.6. **In paragraph 26.148 of the Consultation Paper**, the Authority has stated that the *"Concession Agreement nowhere mentions 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 10.2.1 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 which does not envisage cross subsidy from non-aeronautical revenues to defray aeronautical charges.

4.2.1.5 demonstrates the intention of the Government to protect the economic interest of shareholders and lenders investing in the airport project. Such shareholders/lenders committed their investment based on the financial model which was drawn up taking into consideration the provisions of the Concession Agreement which bifurcated the charges into regulated and other charges. The Central and State Governments who were stakeholders to the financial closure have taken cognizance of this model which reflected an internal rate of return of 21.66%. Further, the business plan which was drawn up on the basis of the Concession Agreement was also shared with the Government. In case the fundamental bid assumptions made at the inception of the project change, the risk associated with the project would change leading to an increased cost of capital. This would also lead to reduced cash flows which in turn would adversely impact the Operator's ability to repay its debts and undertake further expansion of the Airport.

Lastly, the project information memorandum for BIA which was shared with the bidders underscored the following points:

- the government recognized that private participation in commercial projects required the projects to be commercially viable
- non-aeronautical activities were expected to significantly augment the revenues from the aeronautical services
- non-aeronautical operations would form a distinct and significant component of the airport investment and land shall be optimally and innovatively used to maximize commercial and business revenue.

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.

Extracts of the ICAO's Policies on Charges for Airports and Air Navigation Services:

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".*

Extract of the Consultation Paper:

4.3.1.4. As stated in 4.1.1.4, in **paragraph 26.139** of the Consultation Paper,".. *ICAO has no firm policy on the till and hence it cannot be said that it is against either Single Till or 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 BIA 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 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

Extracts of the AERA Act:

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 BIA, 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. Planning Commission View on Choice of Till

4.5.1 Planning Commission View on Choice of Till

Extract of the Consultation Paper:

4.5.1.1. The Authority has in **paragraph 26.86 of the Consultation Paper** referred to the letter written by the Planning Commission to the Authority opposing the Single Till approach.

4.5.2 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.

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 Deputy Chairman both announcing over Rs. 20,000 Crore investment in airports through PPP mechanisms in June 2013.

4.6. Global Precedents in Respect of Airports Adopting Dual Till

4.6.1 Applicability of Global Precedents of Airports Choice on Till

4.6.1.1. 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)

4.6.2 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 BIAL.

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

4.7.1 Applicability of RAB and Treatment of Land / Real Estate

<u>Extract of the Land Lease Deed:</u>

4.7.1.1. A Land Lease Deed was entered into between the Karnataka State Industrial Investment and Development Corporation Limited (KSIIDC) and BIAL on April 30, 2005.

4.7.1.2. **As per Clause 4.1 of the Land Lease Deed**, the KSIIDC granted permission and consent to BIAL to use the site in accordance with the Master Plan to carry out the following activities:

(a) Implementing the project;

(b) Developing, constructing, building, owning, operating and maintaining the Airport;

(c) Designing, building, owning, operating and Maintaining the utilities, services and facilities required for operating and maintaining the airport;

(d) Designing, building, owning, operating and Maintaining and using office, management, administration facilities, including all infrastructure required for such facilities and canteen facilities;

(e) Implementation of plans for expansion, modernization or renovation of the Airport or utilities and services facilities;

(f) Extraction of ground water and harvesting of rainwater for BIAL's requirements;

(g) Developing a greenbelt on the site as specified in the Master Plan; and

(h) Developing and landscaping the site;
(the **"Purposes"**)

As per Clause 4.2 of the Land Lease Deed, *"BIAL may, with the approval of KSIIDC (such approval not to be unreasonably withheld), in addition to the above Purposes, utilize the Site for any other purposes, which in its opinion is (i) conducive or incidental to implementation of the Project; and/or (ii) conducive or incidental to the operation and management of the Airport; and/or (iii) enhances the passenger/cargo traffic at the Airport; and/or (iv) improves the commercial viability of the Project; and/or (ii) facilitates substantive further investment in or around the Airport."*

4.7.1.3. **Clause 1 of the Land Lease Deed** is in respect of 'Definitions and Interpretation'. This section defines **"CA Excluded Area"** as "that portion of the Site containing those **Non-Airport Activities** not being taken over by GoI pursuant to Articles 7.2 or 13.5.2 of the Concession Agreement". Further, it also defines **"SSA Excluded Area"** as ""that portion of the Site containing those **Non-Airport Activities** not being taken over by GoK pursuant to Articles 4.3 or 19.4.2 of the State Support Agreement".

Extract of the State Support Agreement

4.7.1.4. The State Support Agreement for the development, construction, operation and maintenance of Bangalore International Airport was entered into between the Government of Karnataka and Bangalore International Airport Limited on January 20, 2005.

4.7.1.5. **Clause 3.1.1 of the State Support Agreement** states that the Government of Karnataka would make available to BIAL, State financial support of Rs.3,500 million exclusively for the purposes of the airport project.

4.7.1.6. **As per Clause 4.2 (iii) of the State Support Agreement,** BIAL shall "*promote the development of the Non-Airport Activities with the objective of progressively generating a higher share of revenues for BIAL from such activities*"

Further, Clause 10.2 of the State Support Agreement states that *"…GoK recognizes that BIAL may carry out any activity or business in connection with or related to the development of the Site or operation of the Airport to generate revenues including the development of commercial ventures such as hotels, restaurants, conference venues, meeting facilities, business centres, trade fairs, real estate, theme parks, amusement arcades, golf courses and other sports and/or entertainment facilities, banks and exchanges and shopping malls"*

Extract of the Consultation Paper:

4.7.1.7. **As per paragraph 10.11 of the Consultation Paper**, "*While the Authority notes that the agreements referred to by BIAL have permitted the Operator to use the land for the stated purposes which may not be considered as "Airport Activities", it may not be correct for BIAL to benefit from the land being given mainly for the purpose of running an airport. It is not Authority's intention to state that BIAL will be forced to buy the land which has been given to it free of cost, but to pass on the benefit of exploitation of the land given, by reducing the Regulatory Asset Base."*

4.7.1.8. **Paragraph 10.13 of the Consultation Paper** states that "*The Authority did not wish to go into the issue of when the Airport Operator should or should not use any piece of land for non-airport purposes, nor how much land should be so used because it did not want to put any fetters whatsoever on the operational freedom of the Airport Operator in this matter."*

4.7.2 APAO Response

Provisions of the Land Lease Deed and the State Support Agreement clearly outline the fact that in order to make the airport project feasible, the State is providing support in the form of resources (finance, land etc.) to enable BIAL to build, own and operate the Airport. This includes BIAL undertaking non-airport activities as stated in 4.7.1.2 and 4.7.1.6 above.

In the event of the termination or expiry of the State Support Agreement and the Concession Agreement, BIAL has the option to continue to exercise leasehold rights in respect of the SSA Excluded Area or the CA Excluded Area respectively though it would have surrendered the remaining area which was taken on lease. This underlines the fact that these excluded areas were given to the Operator for commercial exploitation whether or not it continued to operate the airport so as to not impair the financially viability of the Operator.

In light of this, the recommendation of the Authority in the Consultation Paper (stated in 4.7.1.7 above) would go against the spirit of the State Support Agreement and the Land Lease Agreement from which it is evident that the very purpose of providing the various resources including land was to make the project feasible. It therefore does not take into consideration the fact that the use of land for non-airport activities was integral to the case for developing the airport and making it financially 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 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-airport activities. For instance, the Bangalore Airport Hotel is saddled with an arbitration award of approximately Rs.3.77 billion. 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 in a way that is retrospective and 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. Such adjustment is also a disincentive for land monetization as it negatively impacts the internal accruals which would have been otherwise available for expansion.

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.

Further, 4.7.1.8 above brings out the dichotomy in the position taken by the Authority. On one hand, it states that it does not wish to go into the use of land by the operator for non-airport purposes and on the other, it is taking an inconsistent position that it wants to pass on the benefit of exploitation of the land given, by reducing the Regulatory Asset Base to the users.

It is also worth noting that the proposed treatment of land used for non-airport activities 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.

4.8. Cost of Equity Calculation

4.8.1 Methodology of CoE Calculation

Extract of the Consultation Paper:

The Authority has proposed:

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

4.8.1.2. To re-lever the asset beta of BIAL at the notional Debt-Equity Ratio of 1.5:1 (Gearing of 60%).

4.8.1.3. To calculate equity beta according to CAPM framework

4.8.1.4. 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

4.8.1.5. To consider a nominal risk free rate of 7.35% (as against 8.6% proposed by BIAL)

4.8.1.6. To consider the asset beta for BIA at 0.51 (as against 0.78 proposed by BIAL)

4.8.1.7. To consider an equity risk premium of 6.71% (as against 8.73% proposed by BIAL)

4.8.2 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 Net 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 BIAL) 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%

*Assignment commissioned by APAO

Further, KPMG India Private Limited was also appointed by BIAL to estimate the fair rate of return and it has estimated the cost of equity for the first control period to be in the range of 23.5%-27.9%.

As can be seen, the Cost of Equity estimates determined by NIPFP (12.02%) and the Authority (16%) are much lower than those arrived by the various consulting firms.

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

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. This is because inclusion of that wider range is likely to bias the results in a way that is at variance with economic commonsense. It is also at variance with the observations from markets such as Thailand, Mexico and

Malaysia as well as China. It thus produces a result which tends to convey 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 BIA (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 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 NIPFP suggests that most have de-facto as much of a 'monopoly' as BIA. 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 0.78 originally proposed by BIAL be considered in determining its CoE.

Equity Risk Premium

The NIPFP paper relies 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 BIAL of 8.73% is difference between the expected rate of return on the market portfolio (17.33%) and the risk free rate (8.60%). The expected rate of return has been calculated based on the ten year annualized return on the 90 days moving average of market return using the BSE Sensex as the market return indicator.

Based on the above discussion, APAO requests the Authority to reconsider the risk-premium to the originally proposed equity risk premium of 8.73%.

Re-levering and Delevering

NIPFP is calculating the CoE for BIAL on the basis of the market value of the GVK transaction (approx. Rupees 44 billions) and not the book value. APAO believes that this is not an accurate approach for the following reasons:

- The transaction involving GVK's acquisition of equity from L&T and Unique Zurich was carried out by a private party and based on the need of the buyer to acquire a stake in the entity. This has little bearing on the CoE
- The market value could theoretically change if a future transaction happens at a lower valuation and it is unclear whether the AERA will then increase the CoE to reflect the lowered market value and debt/equity levels at that point
- AERA's proposed approach leads to a CoE of 9.33% at BIAL
- 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

It is pertinent to note that the Detailed Project Report (DPR) that was signed and approved at the time of financial closure did not envisage the promoters infusing additional equity in the project after the initial investment, and future operations and expansion were required to be funded through internal accruals, return on investment/equity and additional debt funding (if required).

Equity infusion in PPP projects

In Paragraph 13.28.4 of the Consultation Paper, the Authority has stated that *"the Equity brought in by the initial Private Promoters at Rs. 284.6 Crores is considerably less than both (a) the loan by GoK and (b) much lesser than the Public funds constituting the loan by GoK and Equity by GoK and AAI….The Authority infers that the capital constraint indicated by BIAL is probably on account of the shareholders Agreement which inter alia prescribes a cap of Rs. 50 crore that can be brought in by AAI and other covenants in the SHA. This is an issue purely pertaining to the SHA and therefore, an arrangement* *between different shareholders…BIAL, under Clause 4.2 of the Land Lease Agreement can commercially exploit the land in excess of airport requirements. This in view of the Authority is an important Capital Risk mitigating factor…"*

The Authority thus seems to be suggesting that BIAL could overcome its capital constraints through additional equity infusion by the operator and the other shareholders.

Private investors typically have higher gearing and dilute their equity over time in long-term development projects including across infrastructure sectors. This is particularly the case on long-term concession projects where the concession has a definitive term limit. This is because they are only liable to get 'face value' of the investment at the end of the term rather than the 'market value'. This is very different from privately held entities (e.g. Wipro, Infosys, Tata etc.) where the investors get market value at the end of their term. Investors in BIAL will therefore only get face value at the end of the concession period unless they exit before the end of the concession period (such as L&T or Unique Zurich). Table 1 given below outlines the debt/equity levels of a few of the privately owned airports/operators across the world as per their 2011 Annual Report:

Table 1:

Airports with majority private ownership	Debt/equity (Total liabilities)	Debt/equity (Long term Liabilities only)
BAA Group	5.28	4.96
Brisbane	3.12	2.91
Mumbai	2.70	2.13
Brussels	1.91	1.61
Copenhagen	1.64	1.49
Delhi	3.71	2.91
London-Gatwick	3.74	3.45
London-Heathrow	5.87	5.60
Melbourne	3.32	3.23
Perth	5.16	4.80
Sydney	- 8.01	- 7.76
Median	**3.32**	**2.91**
Equity	30.11%	34.37%
Debt	69.89%	65.63%
	100.00%	100.00%

The median value of the debt/equity ratio at major privately held airports is 3.32/2.91 demonstrating the inherent nature of higher gearing for such assets. In addition, the current shareholding of BIAL as defined by the Shareholders Agreement (SHA) outlines a 26% shareholding by public sector entities (KSIIDC and AAI). If this limit needs to be maintained, an equivalent amount of equity will need to be infused by the two public sector entities. However, the Government of Karnataka has already indicated its refusal to infuse any further capital in BIAL.

The original investment of approximately Rs.3.25 billion was invested by the promoters / investors in 2004. The nominal value of this investment after eight years at the end of 2012 is approximately Rs.5.95 billion assuming inflation and current interest rates. It is our view therefore that AERA reconsiders the figure of the original investment with a more realistic figure taking inflation and interest rates into account.

The original DPR submitted to the Government at the time of financial closure (March 2005) did not envisage additional tranches of equity infusion. Instead, it was assumed that the airport would be 'self-financing' based on an appropriate return on the investment and that internal accruals from revenues envisaged under a 'dual-till' regime would fund future investment.

The Authority has also suggested that the land in excess of airport requirements could be commercially exploited in order to mitigate the capital risk. It however needs to consider that such commercial exploitation of land to begin with would necessitate deployment of funds which are inadequate owing to capital constraints.

Further, future investment at BIA through the next control period is likely to include a new runway and a new terminal to meet demand through the period from 2021-26 as outlined in the 2010-11 Master Plan. An additional amount of Rs.10.5 billion would be required for the expansion. Based on the CoE & Single Till methodology proposed by the Authority, we have worked out an example below so as to check whether such an approach of Authority will work in a given Greenfield Airport similar to BIAL structure. It can be observed that sufficient funds will not be available to cover the costs of expansion and meet working capital requirements and financial covenants (DSCR & DSRA - emergency reserves) as outlined in an example in Table 2 given on the next page. The assumptions made for the purposes of this example are given below:

Assumptions	
Return on equity	16.00%
Cost of state support	0.00%
Cost of debt	10.00%
Debt repayment period	10
Equity (Rs. Crores)	375
State support (Rs.Crores)	350
Debt (Rs. Crores)	1,125
Total (Rs. Crores)	**1,850**
Opening RAB (Rs. Crores)	**1,850**
Equity funded	20.00%
WACC	9.32%
Depreciation rate	4.50%

Table 2:

Rs. Crores

Year	1	2	3	4	5	6	7	8	9	10
RAB	1,850	1,808	1,725	1,642	1,559	1,475	1,392	1,309	1,226	1,142
Depreciation	42	83	83	83	83	83	83	83	83	83
Net RAB	**1,808**	**1,725**	**1,642**	**1,559**	**1,475**	**1,392**	**1,309**	**1,226**	**1,142**	**1,059**
Average RAB	1,829	1,767	1,684	1,600	1,517	1,434	1,351	1,267	1,184	1,101
Return on RAB	171	165	157	149	141	134	126	118	110	103
OpEx (pass through)	-	-	-	-	-	-	-	-	-	-
Interest cost	(107)	(96)	(84)	(73)	(62)	(51)	(39)	(28)	(17)	(6)
Depreciation	42	83	83	83	83	83	83	83	83	83
Gross allowable revenue	105	152	156	159	163	166	170	173	177	180
4 % Revenue share (pass through)	-	-	-	-	-	-	-	-	-	-
Net allowable revenue (A)	105	152	156	159	163	166	170	173	177	180
Opening debt	1,125	1,013	900	788	675	563	450	338	225	113
Debt service	219	208	197	186	174	163	152	141	129	118
Interest	107	96	84	73	62	51	39	28	17	6
Principal payment	113	113	113	113	113	113	113	113	113	113
Closing debt	1,013	900	788	675	563	450	338	225	113	-
DSCR assumption	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Revenues required to cover debt service (Debt service X1.4) (B)	**307**	**291**	**276**	**260**	**244**	**228**	**213**	**197**	**181**	**165**
Shortfall (A-B)	**(202)**	**(139)**	**(120)**	**(101)**	**(81)**	**(62)**	**(43)**	**(24)**	**(4)**	**15**

APAO wishes to submit that the capital expenditure (or CapEx) related investment and funding is not covered by the AERA Act and should the Authority's proposed approach be followed, it would negatively impact returns which would lead to a significant shortfall in funds and adversely affect BIAL's expansion plans as shown in the example above.

4.9. Others

4.9.1. Quality of Service rebate

4.9.1.1. 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).

4.9.1.2. The Authority proposes to implement the rebate scheme from 4th 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.

4.9.1.3. **<u>APAO response:</u>**

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.

4.9.2. Cargo, Ground Handling and Fuel Farm (CGF) services

4.9.2.1. The Consultation Paper has proposed to consider revenue from Cargo, Ground Handling and Fuel Farm (CGF) services as non-aeronautical revenue, except for fuel throughput fees.

4.9.2.2. **<u>APAO response:</u>**

APAO submits that revenue share from fuel throughput fee be treated as non-aeronautical revenue. The Consultation Paper does not mention the reasons as to why such revenue share is proposed to be treated as aeronautical revenue. BIAL has concessioned out fuel farm services to a concessionaire and fuel throughput fee paid by IOSL to BIAL is in fact BIAL's revenue share, which is computed in the form of per kilolitre charges. The calculation per kilo litre is a unit of measure and is not reflective of the nature of service. APAO therefore submits that such revenue share be considered as non-aeronautical revenue. APAO further submits that, whether CGF services are provided by BIAL or by third party concessionaires, revenue from CGF services in the hands of BIAL, in line with Concession Agreement, should be treated as non-aeronautical revenue.

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 BIAL owing to the following reasons:

    - The Single Till approach conflicts with the Concession Agreement which has bifurcated the charges into regulated and other charges and there is no express provision related to cross subsidization in the Concession Agreement.
    - By the imposition of Single Till, India could become something of an international outlier, with detrimental effects on its ability to attract major investment
    - It would also run counter to provisions of the Concession Agreement which state that the Government of India will not take any steps or action in contradiction of the Agreement which results in or would result in such shareholders or the Lenders being deprived or substantially deprived of their investment or economic interest in the Project. The shareholders/lenders committed their investment based on the financial model which was drawn up taking into consideration the provisions of the Concession Agreement which bifurcated the charges into regulated and other charges. The financial model and the business plan were also submitted to the Government which took cognizance of these documents during the financial closure
    - Clause 14 of the ICAO policy mentions that the States should adopt an approach to economic oversight that meets their specific circumstances. In doing so, it requires that the legal, institutional and governance frameworks should be taken into consideration when selecting the appropriate approach. It would be essential for the Authority to ensure that the till approach sought to made applicable to BIA 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
    - The scope of the legislative mechanism i.e. the AERA Act mandates Authority to consider concession agreement wherein a Dual Till is envisaged.
    - 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.
    - Global precedents available indicate that the Dual Till approach, which has found acceptance and application globally amongst regulators, be made applicable to BIAL.

- **Regulatory Asset Base and treatment of land/real estate:** 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 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 Deed 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 BIA 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 Net 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 BIAL and urges the Authority to consider the same for determining the beta in case of BIAL. It also wishes to submit that the beta estimate relied upon by the Authority is flawed and that the beta of 0.78 originally proposed by BIAL 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 8.73%.

- **Relevering and delevering asset beta:** APAO submits that the report relied upon by NIPFP should be reconsidered due to the following factors:

  - The transaction involving GVK's acquisition of equity from L&T and Unique Zurich was carried out by a private party and based on the need of the buyer to acquire a stake in the entity. This has little bearing on the CoE

  - The market value could theoretically change if a future transaction happens at a lower valuation and it is unclear whether the AERA will then increase the CoE to reflect the lowered market value and debt/equity levels at that point

  - AERA's proposed approach leads to a CoE of 9.33% at BIAL

  - 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

- **Equity infusion:** Private investors typically have higher gearing and dilute their equity over time in long-term development projects including across infrastructure sectors. This is particularly the case on long-term concession projects where the concession has a definitive term limit. This is because they are only liable to get 'face value' of the investment at the end of the term rather than the 'market value'. An analysis of the major global airports with private ownership indicates that the median of the debt equity ratio is 3.32.

  The original DPR submitted to the Government at the time of financial closure (March 2005) did not envisage additional tranches of equity infusion. Instead, it was assumed that the airport would be 'self-financing' based on an appropriate return on the investment and that internal accruals from revenues envisaged under a 'dual-till' regime would fund future investment.

  The Authority has also suggested that the land in excess of airport requirements could be commercially exploited in order to mitigate the capital risk. It however needs to consider that such commercial exploitation of land to begin with would necessitate deployment of funds which are inadequate owing to capital constraints.

  Based on the CoE proposed by the Authority and the Debt Service Coverage Ratio (DSCR) requirement at BIAL, sufficient funds will not be available to cover the costs of expansion and meet working capital requirements and emergency reserves.

  APAO wishes to submit that the capital expenditure (or CapEx) related investment and funding is not covered by the AERA Act and should the Authority's proposed approach be followed, it would negatively impact returns which would lead to a significant shortfall in funds and adversely affect BIAL's expansion plans.

- **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.

- **Cargo, Ground Handling and Fuel Farm (CGF) services**

  The Consultation Paper has proposed to consider revenue from Cargo, Ground Handling and Fuel Farm (CGF) services as non-aeronautical revenue, except for fuel throughput fees.

  APAO submits that revenue share from fuel throughput fee be treated as non-aeronautical revenue. The Consultation Paper does not mention the reasons as to why such revenue share is proposed to be treated as aeronautical revenue. APAO further submits that, whether CGF services are provided by BIAL or by third party concessionaires, revenue from CGF services in the hands of BIAL, in line with Concession Agreement, should be treated as non-aeronautical revenue.

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