ASSOCIATION OF PRIVATE AIRPORT OPERATORS

APAO/ AERA/2018-19

Date: 5th July 2018

Ms. Puja Jindal,
Secretary,
Airports Economic Regulatory Authority of India,
AERA Building,
Administrative Complex,
Safdarjung Airport,
New Delhi – 110003

Subject: APAO response to Consultation Paper No. 05/2018-19 dated 17th May 2018 in the matter of determination of Aeronautical Tariffs for Kempegowda International Airport (KIA), Bengaluru for the 2nd Control Period (01.04.2016 - 31.03.2021)

Dear Madam,

As the apex industry association of all major private airports operating in India, APAO is pleased to share its responses on the Authority's proposals in the abovementioned Consultation Paper for the kind consideration of the Authority.

At the outset, we would like to highlight that over the years, robust GDP growth and a rapidly growing middle class with increasing disposable income has led increasing demand for air travel subsequently contributing to the phenomenal growth in the Indian aviation sector in the past few years. Several initiatives undertaken by the government in areas of expansion and modernization of airports, enhancement of regional air connectivity, focus on cargo and ground handling services among others have propelled the sector to reach new heights. Improvements in the economy coupled with the initiatives undertaken by the government have witnessed passenger traffic growth from approx. 160 million in 2012-13 to approx. 310 million in 2017-18 and such an unprecedented growth in air traffic would require substantial airport capacity addition.

According to the government's estimates, airports in India will attract an investment of approx. Rs one lakh crore in the next 7-8 years for capacity augmentations and for development of new greenfield airports. Further, as per industry estimates, the Indian aviation sector, is likely to become the third largest aviation market in the world.

While this presents a plethora of opportunities, the need is to focus on developing a thriving civil aviation industry in India with focused policies and a stable regulatory environment for safeguarding the interests of all stakeholders alike and, consequently boosting investments in the sector.

We have reviewed the above-mentioned Consultation Paper issued by AERA. We have also reviewed the Order issued by the TDSAT in the matter of tariff determination for IGI Airport, Delhi for the first Control Period and also the TDSAT Order in the case of Kempegowda International Airport (having reference to Delhi Airport's TDSAT Order).

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Based on this we would like to provide our inputs on certain key matters.

Treatment of Cargo, Ground Handling and Fuel Farm

In the Consultation Paper, the Authority has proposed to consider Cargo, Ground Handling and Fuel Farm (CGF) as aeronautical activities based on the provisions of the AERA Act and considered revenues from such activities as aeronautical revenues.

We would like to highlight that Section 13 of the AERA Act mandates the Authority to consider the concession offered to the airport operators by the Central Government, along with the other agreements, which are a crucial part of such concession. The Act states that "different tariff structures may be determined for different airports having regard to all or any other considerations specified at sub-clauses (i) to (vii)." The Authority is therefore, statutorily obligated to consider all the concessions offered to the airport operators by the Central Government and other stakeholders while determining tariff for aeronautical services.

Clause 10.2 of the Bangalore International Airport Limited's (BIAL) Concession Agreement states that tariff regulation is only to be restricted to Airport Charges defined as "Regulated Charges" as specified under Schedule 6 of the Concession Agreement (including Landing, Housing and Parking Charges, Passenger Service Fee and User Development Fee). Further, clause 10.3 of the Concession Agreement makes it clear that apart from the "Regulated Charges", BIAL is free to determine the charges for facilities and services, which are being provided at the Airport "without any restriction". Therefore, based on a joint reading of Clauses 10.2 and 10.3 it is understood that while the "Regulated Charges" are to be determined by the Authority, the other charges should not come within the regulatory purview.

While from the concession agreement it is clear that CGF revenues are to be considered as non-aeronautical, however, the Authority's has proposed to consider CGF as aeronautical activities. We believe that the Authority's proposal is not in line with the provisions of the Concession Agreement, thereby defeating the spirit / intent of the Concession Agreement and this undermines the freedom granted to BIAL by the concession agreement to determine these charges as per Clause 10.3 of the Concession Agreement.

Further, even the Information Communication Technology (ICT) and Common Infrastructure Charges (CIC) revenue also needs to be treated as non-aeronautical revenues in line with above concession agreement provisions.

In fact, the inviolability of Concession Agreements has also been reiterated in the Tribunal's Order (hereinafter referred to as the "TDSAT Order") dated 23 April 2018. The Order upheld that the concessions offered to the airport operator deserve due respect and consideration by AERA in the tariff determination exercise.

As a key industry stakeholder, we would like to point that the Authority's current proposal would lead to creation of regulatory uncertainty in the operating environment. As a regulatory authority, AERA's main objective is to protect the interests of the airport operators along with those of the airport users and other stakeholders by providing a stable regulatory environment. Regulatory treatments that are inconsistent with the concessions allowed to the airport investors in the Concession Agreement and other

related agreements may have an adverse impact on investors' confidence, thereby hurting the growth prospects of the industry.

In light of the facts and reasons given above, we would request the Authority to kindly consider revenues from Cargo, Ground Handling & Fuel Farm and as well for ICT & CIC as non-aeronautical revenues and accordingly revise its proposal during finalization of the tariff determination Order for BIAL.

Pre-control Period Entitlement

In the Consultation Paper, the Authority has proposed not to consider BIAL's Pre-control Period entitlement viz. period prior to the Airport Opening Date up to notification of powers of the Authority for tariff determination in September 2009.

We would like to draw the Authority's attention to the TDSAT Order, wherein the Tribunal has rejected a technical plea contending that the regulator had no jurisdiction to determine tariffs for a period prior to the notification of its powers in September 2009. The Tribunal upheld that there is no express or implied embargo prohibiting the Authority from regulating prior to notification of its powers for tariff determination. In fact, the TDSAT Order has clarified that any tariff determination exercise left unfinished by the Central Government could be finished by AERA once it was legally constituted.

In addition, para 67 of the TDSAT Order clearly states that the Central Government was fully aware of the tariff determination exercise by the Authority in the case of DIAL for the period as it has issued communications relating to tariff fixation, without any objections. In such a scenario, the Tribunal observed that it would be futile to direct the Central Government to go through the formality of fixing tariffs when it cannot complete the exercise in a meaningful and proper manner so as to avoid retrospect impact and delay. Finally, it was also mentioned that Section 13 of the AERA Act "gives sufficient latitude in selecting an appropriate beginning of the first regulatory term of 5 years subject to rules of transparency and fairness." This clearly dismisses the argument of the Authority not having jurisdiction over the period prior to the notification of its powers.

In addition, we would also like to refer to the letter dated 3 April 2008 issued by the Ministry of Civil Aviation ("Ministry") to BIAL (ref: AV 200015/003/2003-AAI), which explicitly clarifies that the UDFs approved by the Ministry following the commencement of airport operations had been determined on an ad-hoc basis and that the same would be finalized at a later date in accordance with the Ministry's Guidelines and BIAL's Concession Agreement.

Further, the domestic UDF determined by the Ministry in case of BIAL was only notified in January 2009 (ref letter: AV.20036/07/2008-AD), which was seven months after the commencement of airport operations and hence, inconsideration of such prior period shortfall does not seem justified. BIAL suffered shortfall cumulatively for the period since the construction of the airport up till March 2011.

It is pertinent to point out that in case a particular period of airport operation is not considered, the airport operator would incur considerable financial loss. Needless to mention that the losses of the airport operator results to an indirect benefit to the community of airport users at the expense of the airport operator. Economic regulation of the sector aims at ensuring a balance between the interests of different stakeholders

and does not envisage any particular stakeholder being in a better position at the unjustified expense of other. Therefore, not regulating a particular period where aeronautical tariffs were below the regulated levels is clearly a case of enhancement of the interest of airport users at the unwarranted expense of the airport operator.

Accordingly, we would request the Authority to consider the pre–Airport Opening Date and Pre-control Period shortfall for determination of tariffs for the second Control Period.

Consideration of Regulatory Till for true up

We note that the Authority has proposed to consider a 40% Shared Revenue Till (SRT) for true up of the Pre-control and First Control Period in the tariff determination for KIA for the second Control Period.

Based on a conjoint reading of Articles 10.2 and 10.3 of BIAL's Concession Agreement, which distinguishes between the regulated "Airport Charges" and non-regulated "Other Charges", which are to be fixed by BIAL, it is clear that Dual Till was to be adopted for tariff determination. In fact, the Concession Agreement did not envisage any cross-subsidization from non-aeronautical revenue. A comparative study of tariff determination exercises in the case of other PPP airports in the country reveals that the Concession Agreements of DIAL and MIAL had incorporated 30% SRT and the provisions of the Concession Agreement were duly respected and considered by the Authority. It is also pertinent to note that the concessions for both DIAL and MIAL were awarded subsequent to BIAL, which was the first Concession Agreement signed on PPP basis. This indicates an inconsistent regulatory approach by the Authority to consider the provisions of the Concession Agreement only in the case of some airports. This ad-hoc treatment is again reflective of uncertainty in the regulatory environment thereby hampering the investment climate.

Even in the Ministry's letter dated 24 September 2013 cited by the Authority for adoption of 40% SRT in the case of BIAL, the Ministry's 'recommendation' was based on its assessment of the fund requirement for expansion of the airport for that period. However, subsequently the Ministry had issued a policy directive under section 42(2) of the AERA Act, 2008 directing the Authority to consider a 30% SRT in the case of HIAL, including for true up of the Pre-control and First Control Period. Given the similarity in the provisions of the Concession Agreement in the case of BIAL and GHIAL, and the more binding nature of the MoCA directive issued in the case of GHIAL as compared to the recommendation letter issued in the case of BIAL, the Authority is requested to consider consistent treatment across the two airports.

We would therefore like to submit that in the interest of ensuring consistency in regulatory treatments across all airports in the country, the Authority is requested to revise its proposal and adopt a 30% SRT for true of the Pre-control and First Control Period in the case of BIAL as well.

Cap on true up of Project Expansion Cost

In the context of reviewing BIAL's proposed expansion project cost for the second Control Period, we understand that the Authority had engaged an independent technical consultant.

Based on the technical consultant's report, the Authority has revised and brought down the estimated cost of the expansion project of BIAL to Rs 8,167 crore from Rs 10,038 crore, which was requested by BIAL and has also capped the true-up of the expansion project up to 10% over the cost as per the Consultant approval in the third Control Period.

We would like to highlight to the Authority that project cost estimates that were submitted by the airport operator prior to the implementation of the project works were only estimates of the expected expenditure and these cannot be predicted with complete accuracy. Typically, the private airport operators in India have adopted robust practices for competitive bidding for the project works, internal project management practices to control costs etc. However, given the uncertainties on account of fuel prices, costs of raw materials, inflationary pressures etc., the actual costs incurred may vary. Therefore, an estimation of project is an airport operator's best estimate of how the above factors would perform in future.

In fact, even in the TDSAT Order, the Tribunal has held the Authority's plea that any estimation of project cost can only be examined to see if it relates to approved costs and supported by auditor certificates. The Authority's submission, which stated that"...such costs cannot be re-examined on the yardstick of efficient cost but has to be taken as the incurred cost only, as appearing in the duly certified books of accounts", has been accepted by the Tribunal.

In light of the above and the unprecedented rise in traffic at the KIA, we would like to submit that the implementation of airport expansion project works should not get unduly constrained by a cap. We would therefore, request the Authority not to put in place a hard cap on project cost of airports but to consider each escalation from the projections based on merits of circumstances while truing up the project cost.

Consideration of Notional Interest on Security Deposits

We have observed that the Authority has proposed to consider a notional revenue on the Security Deposits collected from non-aeronautical service providers.

We would like to highlight that security deposits are a usual feature in commercial lease agreements, which are to protect the lessor against damage caused to the lessor's property or to ensure timely payments from the lessees. They are not a compensation against rent, most certainly so in cases where rents are benchmarked to comparable contracts in the region and are to address owners risk of non-payment of rents.

We would like to highlight that BIAL's security deposits are in line with the prevailing business practices and rates in the metropolitan region, which eliminates the possibility of them being supplementary non-aeronautical revenues.

In light of the above, we would request AERA to re-examine the manner in which notional revenues has been applied in the case of BIAL and yet not consider them for tariff determination.

Treatment of Property Development

We have observed that the Authority has considered revenues from property development activities as non-aeronautical revenues.

We would like to reiterate our submissions made above that as per Article 10.3, BIAL is free to determine charges "without any restrictions" for activities other than the "Regulated Charges" defined in Schedule 6 of the Concession Agreement. Further, we would like to submit that Schedule 3 of the Concession Agreement clearly defines commercial property development including hotels, SEZs, business parks, commercial buildings, and commercial complexes as non-airport activity and the Agreement does not envisage cross-subsidization of the aeronautical revenues using the revenues from non-airport activities.

Also, according to Clause 4.1 of the Land Lease Deed (LLD), BIAL can undertake both airport and non-airport activities without seeking any prior permission. In addition, we would like to highlight that the development of a Greenfield airport (like BIAL and GHIAL) involves high level of investment and are fraught with risks and therefore, the grant of land for commercial purposes over the concession period was aimed at, as a commitment forming part of Concession Agreement, generating additional revenue sources to ensure sufficient returns.

In such a scenario, the Authority's proposal in the consultation paper is against the assured commitments in the Concession Agreement as well as the Land Lease Agreement. This would significantly affect the feasibility of the non-airport activities. The supremacy of the Concession Agreements has also been upheld in the TDSAT Order as has been mentioned earlier.

We would also like to point that there is precedence, wherein the regulator has kept the income from landside property development outside the Till in consideration of the concession provision.

In lieu of the above, the Authority is requested to undertake the tariff determination exercise having consideration to the provisions of the LLD and the Concession Agreement and treat commercial property development outside the purview of regulation / regulatory till.

Treatment of lease rentals from aeronautical service providers

The Authority has proposed to consider revenues earned by BIAL from aeronautical service providers as aeronautical revenues.

Typically, airline companies and other aviation agencies require space within the terminal building to carry out their day-to-day business operations. We would like to draw the Authority's attention to para 2.4.1 of Consultation Paper No. 05/ 2018-19,

wherein "airline offices" have been defined as non-aeronautical services by the Authority itself.

Even as per the AERA (Terms and Conditions for Determination of Tariff for Airport Operators) Guidelines, 2011 ("Airport Guidelines"), airline offices have been recognised as "Commercial office areas". These areas are to be treated as "Revenue Generating Areas" alongside retail, advertisement, ticketing, duty free shops and car parking, as prescribed in Form F3 of the Airport Guidelines.

Also, we would like to refer to ICAO's Airport Economics Manual (Doc 9562), which provides a list of "Revenues from non-aeronautical activities". According to para 4.23, non-aeronautical activities includes rentals payable by aircraft operators for airport-owned premises and facilities (e.g. check-in counters, sales counters and administrative offices) apart from those which have already been covered under "air traffic operations".

In order to ensure that principles adopted globally are implemented in the country and interests of the airport operators are not unduly compromised, we would request the Authority to have a uniform approach and consider lease rentals as non-aeronautical revenues.

Treatment of BIAL's equity investment in the hotel for the purpose of FRoR determination

The Authority has reduced BIAL's investment in its hotel subsidiary BAHL from BIAL's equity while computing a fair rate of return to be allowed on BIAL's aeronautical RAB.

While on one hand the Authority has treated the revenues from BAHL as non-aeronautical revenue, on the other hand it has ring fenced the investment in Hotel which is contrary and inconsistent in nature.

Accordingly, we would request the Authority to consider the capital structure of the entire airport entity as a whole rather than dividing the same into multiple fragments, to avoid such complexities and to maintain consistency across airports.

Reduction in Opening RAB

It has been observed that the Authority has proposed to consider a reduction of Rs 69.45 crore in the initial project cost based on the findings of the report submitted by the Engineers India Limited (EIL).

In the EIL report it has been observed that BIAL's overall costs appear to be in order and undertaking comparison of the cost incurred with respect to the market rates is a complex activity.

Further, we would like to highlight that there seems to be an unfair consideration of only those costs differentials wherein the actual costs incurred by BIAL exceed the EIL estimates. These differentials were not set off against those wherein, BIAL's incurred costs were lower than EIL's estimates.

Also, in the TDSAT Order, the Tribunal has accepted the Authority's position that costs need to be taken as incurred costs and should not be re-examined on the yardstick of efficient costs as has been mentioned earlier in our submission. Therefore, by relying on a post-facto report submitted by EIL that attempts to estimate cost-efficiency, the Authority is going against not just its own stated position in the Tribunal but also against the Order issued by the Tribunal.

Accordingly, we would request the Authority to maintain consistency in its regulatory treatment and positions and consider the project costs as submitted by BIAL supported by auditor certificates.

Treatment of Corporate Social Responsibility Costs

It is observed that the Authority has proposed to disallow expenditure pertaining to Corporate Social Responsibility (CSR) as part of the tariff determination exercise.

As per the Airport Guidelines, operation and maintenance expenses shall include all expenditures incurred by airport operators including statutory operating costs. We would like to highlight that expenses incurred on CSR is a statutory requirement mandated by the Companies Act, 2013 and hence, such costs incurred by airport operators would fall under the category of statutory operating costs defined by the Airport Guidelines.

Further, while the Authority is of the view that CSR cost is an appropriation of profit, we would like to submit that it is instead an "above the line" item, which reduces the net profit of the airports.

Accordingly, we would request the Authority to allow CSR costs in the nature of statutory costs to be incurred by airport operators and consider the same while determining final tariffs.

Conclusion

It is understood that as per the Authority's proposals, BIAL is likely to end up with a negative cash flow by the end of the second Control Period. With 92% of the internal accrual generation of BIAL having already been reinvested for improving the airport capacity to handle the increasing demand of passenger and cargo growth, and in the absence of any further equity infusion, BIAL may face severe constraints with respect to funding its proposed airport expansion project during the second Control Period. Given the escalating traffic at Bangalore Airport, it is pertinent to note that any deferral of the airport's expansion plans to the third Control Period would choke the airport due to capacity constraints and lead to deterioration in the airport's service levels.

To highlight the sanctity of the Concession Agreements for tariff determination of PPP airports, we would like to submit that in 2004-05 when the Concession Agreements of BIAL and GHIAL were signed, India's aviation industry lacked a defined regulatory mechanism to determine aeronautical charges. In the absence of a defined framework, Concession Agreements along with discussions with the Concessioning Authority were the sole premise for all financial analysis and corresponding investments decisions

taken by bidders. The Authority was subsequently established in 2009, after the projects were awarded for development and operation of these airports.

In this context, we would request the Authority to take into consideration an understanding of the importance attached to Concession Agreements while determining the tariffs for such airports. From an industry perspective, the Authority's positions in the above consultation paper, which are incongruous with the Concession Agreements takes the sector by surprise and would undermine investor confidence in the privatization initiatives of the Government going forward.

Therefore, in light of all our above submissions, we would request the Authority to consider the following while determining tariffs for BIAL for the second Control Period:

i. To consider revenues from Cargo, Ground Handling & Fuel Farm and as well ICT & CIC as non-aeronautical revenues
ii. To consider the pre–Airport Opening Date and Pre-control Period shortfall for determination of tariffs for the second Control Period
iii. To adopt a 30% SRT for true of the Pre-control and First Control Period
iv. To remove cap on true up of project cost of airports and instead consider each escalation from the projections based on merits of circumstances
v. To not consider notional interest on security deposit for purposes of regulatory tariff determination
vi. To treat commercial property development outside the regulatory till and consequently, any revenues arising from it to not be considered for tariff determination
vii. To consider lease rentals as non-aeronautical revenues
viii. To not consider ring-fence BIAL's investment in BAHL from equity while computing FRoR
ix. To consider the initial project costs as submitted by BIAL supported by auditor certificates without considering any reductions mentioned in the EIL report
x. To allow expenditure pertaining to Corporate Social Responsibility (CSR) as part of the tariff determination exercise.

We look forward to your kind consideration of our above submission on the Consultation Paper.

We shall be pleased to provide any further information / clarification, if required, by the Authority.

Thanks and Regards
For Association of Private Airport Operators

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