FAIRFAX
FINANCIAL HOLDINGS LIMITED

26th June 2018

The Chairman,
Airports Economic Regulatory Authority of India
AERA Building
Administrative Complex
Safdarjung Airport
New Delhi 110 003

Dear Sir,

This is in reference to the Consultation Paper released by the Airport Economic Regulatory Authority (AERA) for the 2nd Control Period tariff determination for Kempegowda International Airport (KIA) vide No. 05/2018-19.

As you are aware, Bangalore International Airport Limited (BIAL) is Fairfax's largest investment in India. This reflects our confidence in India and in particular the growing Indian Civil Aviation sector, of which airports are an important constituent.

The tremendous growth in air travel has prioritised the need for capacity addition and expansion of the airport infrastructure. India is slated to be the third largest aviation market in the world by 2030 and creation of new capacity along with modernization and upgradation of the existing airports is vital. The Bangalore airport is also experiencing high growth in traffic and we are now 3rd largest airport in the country. I am also aware of the Government's thrust on sectoral growth as is evident from the various measures and policies being promulgated to match the increasing demand for air travel.

We are in the midst of huge expansion plans consisting of mainly Airfield projects for 2nd Runway, Taxiways, Apron, Terminal 2 and other associated projects. A Capital outlay of around Rs. 11,000 Crores is estimated for the future expansion projects and we have made considerable progress in execution of these projects.

This is a very important period for the airport as it seeks approval for its capital expenditure and for the right level of tariff so as to be able to fund this massive expansion program.

In this regard, I have to share some concerns with respect to the consultation paper referred to above, that could be a major setback for our expansion plans. Despite the positive intent of the Government and the regulatory authority in terms of progressive policies and approach, the sector could not attract the requisite private investments in airport projects. This is mainly on account of policy and regulatory uncertainties in the implementation of the provisions of the Concession Agreement (CA). We have seen inconsistency in the application of the policy amongst similarly placed airports and this approach has also been noted in the current Consultation Paper issued by AERA.

I wish to highlight some of these issues and make the following submissions with respect to certain major proposals in the CP that will impact significantly the performance of the

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Airport and in particular will constrain the Airport in proceeding with capacity enhancement initiatives. We request you to kindly consider the same and safeguard the terms of the Concession Agreement and avoid any inconsistency in application of the policy measures that puts our airport in a disadvantageous position.

1. 30% Shared Revenue till not applied in case of BIAL for the 1st Control period which is inconsistent to the approach taken to another similarly placed airport.

The Regulatory Till adopted by AERA is different from the Till mechanism provided for in the Concession Agreement. As per the Concession agreement, tariff regulation was envisaged for "Regulated Charges" consisting of landing, housing and parking, passenger service fee and user development fee. Further, there is no provision in the Concession Agreement to consider any cross-subsidization from other revenues for determination of Regulated Charges clearly implying Dual till approach.

Inspite of the above, we accepted that 30% Shared Revenue Till (SRT) as a workable solution and represented to Ministry and AERA. Initially Ministry recommended 40% SRT for BIAL. However, later the Ministry recommended 30% SRT as a policy directive for Hyderabad airport with retrospective effect. We request AERA to consider similar approach of 30% SRT in the case of BIAL as well. Such an approach by AERA will ensure treatment at par for the similarly placed Bangalore and Hyderabad airports, and also ensure consistency with the policy directions under the National Civil Aviation Policy.

2. Pre-Control period losses not considered for tariff determination by AERA

A letter from The Ministry (ref: AV 200015/003/2003-AAI dated 03.04.2008) to BIAL mentions that the UDFs approved by The Ministry upon opening of the airport were determined on ad-hoc basis and that a final decision in that regard was yet to be taken. The letter also states that the tariffs were interim in nature and would be finalized at a later date as per the Guidelines of the Ministry and the Concession Agreement.

However, the AERA proposes to compute Pre-control period shortfall/ over recovery of revenues from the period the AERA has jurisdiction (September 2009) and not to consider the pre - airport Opening Date losses and losses incurred prior to September 2009. As per the AERA, it does not have jurisdiction to regulate over a period prior to the date the powers under Chapter 3 of the AERA Act 2008 were notified.

We would like to submit that the Concession Agreement contains explicit provisions which assures the appropriate tariff determination either by Ministry or AERA as the case may be. As explained above, initial tariffs were determined on adhoc basis by Ministry and AERA needs to consider these adhoc tariffs from the date of inception rather than from September 2009 while computing Pre-control period shortfall/ over recovery of revenues. Any different approach by AERA will result in a situation wherein Airport will not be compensated for its due performance. In lieu of above, we request AERA to consider the pre- control period losses in its entirety and allow BIAL to recover the shortfall of revenue incurred during Pre-Control Period.

3. Cargo, Ground Handling and Fuel (CGF) revenues considered as aeronautical revenue in contravention to the provisions contained in the Concession Agreement.

In reference to Article 10.2 and Article 10.3 of the Concession Agreement together with Schedule 6, the CGF services and corresponding revenues were not provided as part of "Regulated Charges". Accordingly, CGF revenues are not to be considered as aeronautical revenues and not to be utilised for any cross subsidization. However, contrary to Concession Agreement provision, CGF revenues were considered by AERA as non- aeronautical revenue and substantially impacting the commitment that were made as part of the Concession Agreement and other Project Agreements.

We hereby request AERA to consider the similar treatment as provided in case of Mumbai and Delhi airports in adherence to provisions of the Concession Agreement and ensure that CGF revenues were considered as non-aeronautical revenues while determining tariff for Bangalore airport.

4. **Treatment of Real Estate as non-aeronautical income is not as per Concession Agreement**

As part of the bidding process in order to attract potential investors, certain incentives were provided in BIAL Concession Agreement. The project Agreement consisting of land Lease deed, allows the utilization of land for airport activities and non-airport activities. The non-airport activities refer to Hotel, commercial building, SEZ which are in real estate realm and not connected with airport business. The recent Consultation paper proposes cross-subsidization from Real estate which was not in line with the provisions of Concession Agreement, Land Lease Deed and other Project Agreements. Any dilution of commitments as provided in the project agreements will severely affect the investments in the project.

The Real estate requires considerable investment, entrepreneurial acumen and risk taking ability and return on these investments accrue after a long gestation period. Cross-subsidization from these revenues will prove detrimental to attract further investment in the sector and hence we request that the AERA should keep these activities outside the purview of regulation and hence the same should not be considered as part of regulatory till.

5. **Inadequate returns being provided by AERA which is not in line with the original bid premise.**

The success of PPP to a large extent depends on optimal risk allocation amongst stakeholders, robust enabling ecosystem, sound regulatory and arbitration framework to ensure smooth implementation of projects. It is important to note that the Concession Agreement has elements to protect the economic interest of shareholders and lenders investing in the airport project. The shareholders/lenders committed their investment based on the financial model which reflected an internal rate of return of 21.66%. The Regulatory approach of providing 16% return on equity investments in aeronautical assets has translated into an even lower return on equity which does not reflect the risks involved and the high uncertainty in these projects.

We request the AERA to look at allowing reasonable returns, based on Capital Asset Pricing models, and recommend a fair rate of return to the airport investors.

In order to attract the requisite sum of investments and to ensure that the sector is poised towards a compelling future, the regulatory framework must adhere to the Concession Agreement and other allied Agreement.

6. **Most importantly, the tariffs determined should provide the cash flows required to fund and complete the planned expansion of the airport.**

The current consultation paper proposal of the AERA on tariff and capital expenditure show a negative cash flow and results in cash flow gap of approx. Rs. 1,489 Crores for BIAL. This poses a huge challenge as far as funding the project is concerned.

It is very pertinent to note that 92% of the internal accruals / net earnings of BIAL since the opening day (May 2008) has been retained in the business and not distributed to the investors. They have been reinvested to build, enhance and renew the Bengaluru airport capacity to handle the increasing demand of passenger and cargo growth.

It is also important to note that government shareholders i.e. AAI and GoK combined together hold 26% equity in BIAL and both AAI and GoK have informed earlier that they will not be able to infuse additional equity in BIAL. As per provisions of Share Holders Agreement, the total equity holding of AAI and GoK together should be 26% at all times and no dilution in their stake is possible. Based on the above, in 64th Board Meeting of BIAL held on 16.05.2013 it was resolved that none of the promoters would be in a position to infuse further equity into the project. Having no recourse to infuse further equity, financing the airport expansion project during the second Control Period poses a massive challenge.

Additionally, our lenders require us to maintain certain minimum financial covenants including (i) interest coverage ratio, (ii) debt service coverage ratio and (iii) fixed asset coverage ratio. Based on the AERA's business plan, BIAL would default in meeting these financial covenants and this could lead to penal interests and re-pricing of BIAL's debts, which will have a significant impact on our ability to take financing / long term debt for the future expansion projects.

Any delay or deferment of the expansion to the 3rd Control Period would result in stagnation and choking of the airport due to capacity constraints. Hence, it is sincerely requested that the AERA may consider allowing BIAL to continue its existing tariffs over the remaining period of the 2nd Control Period. The surplus tariffs allowed to BIAL over the period could be clawed back at the time of the 3rd Control Period on a net present value basis. Such an approach would also result in terms of smoothening of tariffs across the regulatory periods and thereby reducing the tariff shocks to end users.

I have full confidence that you would kindly consider the above matters so as to enable BIAL to serve the growing needs of the Civil Aviation industry in India.

Thanks and Best Regards,

V. P. Watsa

Prem Watsa
Chairman & Chief Executive Officer
Fairfax Financial Holdings