ASSOCHAM
INDIA

THE ASSOCIATED CHAMBERS OF COMMERCE AND INDUSTRY OF INDIA

D S RAWAT
Secretary General

8th December, 2014

Dear Sir,

Subject: Paper on Normative Approach to Building Blocks in Economic Regulation of Major Airports

This is in reference to the Paper on Normative Approach to Building Blocks in Economic Regulation of Major Airports in India issued by Airports Economic Regulatory of India, Government of India.

On behalf of ASSOCHAM, we would like to thank the Airports Economic Regulatory of India for inviting our response. Please find enclosed copy of the same for your kind reference and kind consideration.

We look forward to your guidance and support as always.

Thanking you with warm regards.

Yours sincerely,

(D. S. Rawat)

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ASSOCHAM Response on Normative Approach

Indian Infrastructure sector required USD 1 trillion of investments in the 12th Five-Year Plan. Planning commission expects USD 500 billion (or 50% of total) capital from private players in next 5-year plan period (12thplan). In sectors such as aviation, the contribution is expected to be even higher at approximately 75%.Hence preserving the interest of equity investors becomes the prime importance, to achieve future growth in Infrastructure which is key enabler for all other industries and the economy as a whole.

The Authority has recently published a Consultation paper on Normative Approach for determining Tariff at Major Airports in India. In response to the same, we would like to humbly submit the following:

General Methodology for Framing Norms:

Authority should be creating Norms or Benchmarks only for testing purposes and not for penalizing the Industry.After finalization of norms Authority in its review process, should take a judicious call whether the upside deviation from the norm is justified or not and if some saving is done then Authority should at least be rewarding the same by allowing the benchmark cost.

Secondly, Authority while determining any such norms should take into account the factual experiences of recent past and these norms should be based on some industry expert/consultant's observations or findings. However, in the current consultation paper barring few proposals framed from Inter-Ministerial Group's (IMG) recommendations, none of the proposal appears to be clearly based on factual experiences of the industry. Instead, Authority has relied on experiences from other sectors, which may not be depicting the true picture of the regulated industry or has arbitrary considered a figure which does not represent a benchmark. We appreciate the Authority's motive of providing the best to all stakeholders, but this should not be done at the stake of the equity investors. Authority should appreciate the fact that Private Equity investors shares the burden from Governmentfor developing the desired infrastructure well in time for development of the Economy as a whole and should be duly rewarded for the risk taken and for their precious time and money invested in developing the infrastructure.

The Authority should also appraise the point that these norms should be dictated through the concession agreements awarded to private parties. The Inter-Ministerial Group (IMG) has stated that norms should be put across prior to privatization and through the bidding process. Therefore it is humbly submitted to the Authority that existing privatized airports to be kept out of these norms. And for future privatization

Authority can take necessary steps, so that these norms can be framed as part of the bidding process.

However,following is the detailed contention in response the various proposals issued by AERA:

Proposal No. 1. Regarding Debt-Equity Ratio and WACC

The Authority's proposal of Debt Equity Ratio of 70:30 is based on the regulation laid by Central Electricity Regulatory Commission (CERC) for Electricity generation and transmission. Notably, the norms of 70:30 Debt equity laid by CERC is only applicable at start of project and thereafter the actuals are followed for tariff determination.

However, Authority in its current proposal has not clearly mentioned and clarified that whether the proposed norms is to be adhered at the COD or throughout the Concession life. Life of infrastructure project in airport is around 60 years. Authority should appraise that maintaining a Debt Equity ratio throughout the project life or concession life would be tedious task, as lenders may or may not agree to lend for that long time horizon.

Further, Authority in its proposal has stated to treat 'Net Worth' as Equity contribution for calculation of Debt Equity ratio. It appears to be a welcome approach for the industry, however Authority needs to take a cautious call for entities which are not able to generate profits and have a negative 'Net worth'. Otherwise this proposal can be a double whammy for entities which are facing a hard time.

Secondly, Lender while lending to any project lays down several restriction for distribution of surplus to Equity shareholders to secure timely and due payments to the lending institution. Such restrictions at times results into accumulation of retained earnings, with the current proposal equity holders would lose on their desired return from the investment if the said retained earnings is treated as normative debt. Therefore it is earnestly requested that Authority should reconsider the current proposal and provide the due return to the investors on the equity invested.

Proposal No. 2. Regarding fair rate of return on Equity

The Authority in current consultation while determining the fair rate of return has relied on estimates of National Institute of Public Finance (NIPFP). As stated by Authority it is based on comparative sets from both developing and developed regions. Authority should appraise the point that Indian Economy is more in line with developing economies of the world, Investors across the globe look at India as a developing economy. Developed Economies have a much stable regulatory structure, whereas developing economies like India the regulatory framework isstill in a very nascent stage. Authority themselves have noticed the same while benchmarking the proposals for Operating expenses and Non Aeronautical revenues (i.e., Proposal 4 and Proposal 8 of the Current Consultation paper). Therefore it would be more prudent to use only the comparative set of developing economies as done by the other private consultation, as these would represent a much true picture of India Economy and the risks associated with any investment in a developing economy.

Secondly, Authority should also keep a note and provide an appropriate trade-off for the risk formalised in the form of Proposal No. 1 (i.e., A Higher Debt Equity ratio) in the current proposal of fair rate of return. Authority should revisit the working of fair return allowed and ensure that appropriate adjustments are done to make it a level playing ground.

Proposal No. 3. Rate of Depreciation (Useful life of assets)

We are in consensus with the Authority in respect of this proposal. Authority should evaluate and determine the useful life of typical airport specific asset which are not clearly stated by the New Companies Act. However, a more detailed consultation may be required for the same. As a best practice, the Authority should look for domestic and international illustrations to set up these depreciation rates.

Proposal 4: Regarding Operation and Maintenance Expenditure

We welcome the Authority's thought process of truing the O&M expenditure. This is the right step to support the airport operators and entice the private investors for the future privatization of the airports. At the same it provides a level of comfort for the investor to manage any unanticipated expenditure. This holds good as industry as of now is in developing stage.

Proposal 5: Regarding norms for Capital Costs

Authority has already slated the procedure for Assessing the Capital expenditure, as well as stakeholder consultation in its Airport Guidelines, which is a very robust process of evaluating and minimizing the cost passed on the various stakeholders. The Authority has already laid detailed protocol for stakeholder's consultation which takes into account views of all the relevant stakeholders. Thereafter putting a Normative capping on the Capital cost is over burdening for the industry. Therefore it is earnestly, requested to the Authority that they should follow the process which is already laid down and accepted by all the stakeholders. If Authority still feels that there is scope for pilferage then they may further strengthen the process which is already laid.

Further, creating a benchmark or a general norm for airport terminal cost is not possible, as this is dependent on various factors such as location, time of construction, expected level of service standard and quality parameters. Even IMG while framing guidelines for Airport terminal designing has noted the same and therefore refrained from creating any such norm. Hence it is earnestly, submitted to the Authority that they should follow the existing process and should abstain from creating any benchmarks for capital cost.

Even after taking into account the aforesaid prepositions, if Authority proposes to go ahead and determine a benchmark, then it should take into account the factual experiences of recent past and these norms should be based on some industry expert/consultant's observations or findings.

Proposal 6 and 7 : Regarding Aeronautical and Non –Aeronautical Allocation

The proposal floated by the Authority for dividing Assets and Operating Cost in Aeronautical and Non-Aeronautical is based on figures derived by the IMG Norms. Notably, Authority's own analysis of allocation has indicated that this ratio is around 85:15. However, Authority in its proposal has arbitrarily considered the maximum percentage indicated by the IMG. This approach would lead to penalize the airports especially, the Greenfield operations which needs time to mature and are operating at a low passenger throughput.

Even the IMG norms states that normally, the commercial area is range of 8% to 12% of terminal area, only in case of big terminal facilities it can go up to 20% of overall area. Therefore it is earnestly requested to the Authority that instead of relying on the maximum possible area, Authority should take inference from their factual experience and determine a ratio accordingly.

Proposal No. 8. Regarding incentivizing airport operator to increase NAR and Truing up

The Authority's proposal does not appear to yield anysignificant benefit to the equity investors. To the extent, the proposal penalizes the operator for not achieving very high growth rates in non-aeronautical revenues.According to the proposed norm, efficiency will be penalized because the more the airports perform, the more would they have to achieve.

However in our view no major airport privatization in world has been done on single till and as such Authority should review its proposal of Single Till for Hyderabad and Bangalore airports. The soft touch approach is the right step as done in case of cochin and that's the way world is going. In UK Hethrow is the only airport under regulation with rest of them being deregulated or shifted to soft touch regulation. In Australia only Sydney is regulated and that also under soft touch. Similarly in New Zealand also all airports are under soft touch regulation.