Express Industry Council of India

EICI/AERA/057
May 02, 2017

Secretary,
Airports Economic Regulatory Authority of India,
AERA Building,
Administrative Complex,
Safdarjung Airport.
New Delhi - 110003

<u>Sub: Capping the percentage of Royalty / Revenue Share payable to Airport Operator as a "Pass Through" Expenditure for the Independent Service Providers providing Cargo facility, Ground Handling and Supply of Fuel to the Aircraft at Major Airports.</u>

Madam,

As requested please find below our comments on the subject matter. We appreciate the attention paid by AERA on the topic of royalty as it is presently applicable on many services on which it should not be charged at the first place and once rationale as well as basis of royalty is clearly stipulated, it must not be more than single digit instead of the current proposal of 30%.

Background: We welcome the Authority's proposal to cap Royalty and Revenue Share payable to Airport Operators.. We do not agree that there should be a blanket cap of 30% on Royalty as it is excessive. As this area has remained un-regulated there has been a manifold increase in royalty rates charged by private airport operators. In the past prior to privatization the royalty rates ranged from 5% to 13% and were later increased to 19%. As the private airport operators raised their royalty charges, Airport Authority of India (AAI) soon followed suit and on 1st August, 2012 increased it to 32.5% as there was no regulatory restriction in place. At present certain airport operators are charging royalty rates as high as 45%. It is also pertinent to add that given that the Authority as per its own benchmark caps profits for the Independent Service Provider (ISP) and the Airport Operator, a 30% cap on royalty is not only incommensurate but makes the actual cost of service inflated by almost 45% which is neither just nor desirable for the airport sector and clearly shows an artificial increase in costs.

1. Need for cap on royalty: As pointed out by the Authority, some of the airport operators are charging unreasonably high royalty/ revenue share from the ISP's. Further there is no regulation at present to deter charging of exorbitantly high rates of royalty revenue share by the Airport Operator. The rates charged for services do not seem to be commensurate with the cost or quality of service provided, which in certain cases does not even entail providing any service.

   It is pertinent to add here that while AAI was a government undertaking and the royalty rates were always within control as AAI being a government agency also had the mandate to ensure that there is no unjust enrichment and transaction costs were contained. However after privatization of airports and with no regulation royalty rates

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have seen a tremendous increase which has been on no rational or logical basis thereby making transaction costs of doing business prohibitive.

At present royalty is charged from almost all ISPs without any justification or logic. Royalty charges appear to be one loophole, as they are unregulated hence provide revenues to airport operators without any cap. In the absence of any clear guidelines not only do airport operators demand any rate of royalty without any fear, even the services for which royalty may be demanded are unclear.

Royalty has in effect become a toll at the airport gate and any one entering the airport is asked for royalty. Despite charging royalty to ISPs in certain cases even if a vendor provides a service to the ISP such service provider of input services too has to pay royalties. Hence in effect the royalty is charged at the input stage and the output stage or double royalty.

It is pertinent to add that the issue of Royalties is a much larger and complex question as has been extolled in various judgements of the Apex Court on the issue of whether royalty is a tax or a charge and if so what is the Constitutional mandate and statutory enactment which permits charging of royalties. **Hence without verifying the legal provisions permitting charging of royalties, no cap should be decided. Once the legal provisions are studied and verified and the justification for charging royalties is established, then only should any cap be decided upon.** The cap has to be based on certain objective criterion and not arbitrarily fixed.

2. What is royalty and why applicable: In order to understand the need for capping royalty fees, we first need to understand as to what is royalty and what is the justification for charging it.

   Blacks Law dictionary defines Royalty as under:

   "A payment reserved by the grantor of a patent, lease of a mine, or similar right, and payable proportionately to the use made of the right by the grantee."

   " A royalty is a payment to an owner for the use of property, especially patents, copyrighted works, franchises or natural resources. A royalty payment is made to the legal owner of the property, patent, copyrighted work or franchise by those who wish to make use of it for the purposes of generating revenue or other such desirable activities. In most cases, royalties are designed to compensate the owner for the asset's use, and they are legally binding."

   Business Dictionary definition of Royalty rate:

   "The royalty rate or the amount of royalty charged per product or service depends on the type of royalty fee for which a party is paying."

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Origin of the word royalty

Late Middle English: from Old French roialte, from roial (see royal). The sense 'royal right (especially over minerals') (late 15th century) developed into the sense 'payment made by a mineral producer to the site owner' (mid19th century), which was then transferred to payments for the use of patents and published materials.

The above makes it clear that a royalty may be charged as a fee in lieu of a grant of a right or a concession by the person charging the royalty. Hence royalty payments are in lieu of a concession granted by the Airport operator to the ISP or say an opportunity to cost i.e. had the Airport operator performed the same service on its own. Hence the royalty can only be capped at the amount that an Airport Operator would have earned had he performed the service himself. This is the key underlying rationale for charging a Royalty fee by the Airport Operator.

Clearly the quantum of royalty cannot be more than what the Airport Operator would earn if the performed the same service himself, which he is permitting the ISP to perform. it defies all logic as to how they can claim high royalties as high as 32.5 % or even 45% in some cases. This would amount to legitimizing returns of 45%.

It is also pertinent to point out that in most cases Royalty and rent in terms of License Fee are charged at the same time. This is a windfall for Airport Operators as not only do they get rent for the land they provide, they also get profits based on investments made by the ISP. In the Minimum Guarantee model a minimum fixed royalty fee is also charged irrespective of the revenues generated by the ISP. In the absence of clear guidelines this practice continues and it is imperative that AERA set out clear guidelines for the same.

3. Impact on high royalties: As a result of non-regulation of Royalties the following consequences emerge

   - The profitability of the ISP is low due to high rate of Royalty payable by ISP to the Airport Operator
   - This limits the capability of the ISP to upgrade facilities and quality of service to keep costs down
   - There is no incentive for the Airport Operator to invest in expansion and modernisation of facilities as his royalty is fixed and even guaranteed in some cases.
   - The ultimate user bears these additional charges and very often they are unaffordable thereby limiting the growth of the sector.
   - Increases transaction costs of doing business in India
   - There is no direct co-relation between costs incurred by airport operator and the Royalty charged which is arbitrary and hence therefore not consistent with the policies of ICAO relating to tariff determination
   - Even if Royalty is capped, other charges will be increased and it is imperative that an alternate mechanism for monitoring increase in demand from Airport Operators is worked out to ensure that capping does not lead to increase in other demands

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Royalty in the context of an airport operator and factors to be considered

4. In the context of an airport operator in order to fix the rate of royalty, instead of a blanket cap, the cap should be based on certain rational and tangible considerations which include the following:

    - Is the Airport Operator providing any service and if so is he paying service tax for providing such services ?
    - What are the investments made by the Airport Operator for the ISP based on which the demand for royalty is being made
    - What is the profit margin of the Airport Operator and is it consistent with the Royalty being demanded as the royalty cannot be in excess of the profit percentage of the Airport Operator
    - What are the risks that the ISP takes and what is the risk of the Airport Operator
    - Impact on growth of the sector
    - Impact of Royalty rate on sustainability and growth of service
    - Overall transaction cost to end user

5. Hence our recommendations are as under:

    - **A thorough review of the legal basis of charging royalties** be undertaken before any decision permitting royalties is taken
    - Detailed guidelines be issued defining the circumstances in which royalty may be charged more specifically if they can be charged on input costs such as engagement of vendors.
    - In view of the above the Authority should call for a more detailed study of the factors outlined above based on which clear guidelines should be issued for determination of the cap on the Royalty rate rather than a blanket cap cutting across all sectors.
    - The Royalty if legally tenable should be capped to a maximum of a low single digit logically derived.
    - Based on the recommendations, a time frame for renegotiation of the Royalty rates should be given to ensure that the reduction in royalties has a tangible impact on the reduction of the overall cost for end users.

We would be happy to make a presentation in person as and when required.

Yours sincerely,
For Express Industry Council of India

Vijay Kumar
Chief Operation Officer