MAFFFL
Mumbai Aviation Fuel Farm Facility Pvt. Ltd.

MAFFFL-FIN-AERA-967

9th October 2017

To
Mr. Rajesh Khanna,
Assistant General Manager (Finance),
Jt. GM, ODS – II,
Airport Economic Regulatory Authority of India,
AERA Building, Administrative Complex,
Safdarjung Airport,
New Delhi – 110003

Sub: Submission of response on the Consultation Paper (CP) No. 28/2017-18 issued by Airport Economic Regulatory Authority.

Dear Sir,

MAFFFL has approached the Authority with its MYTP seeking approval on Tariff for FIC of Rs 882 per KL, whereas Authority has proposed rate of FIC as Rs 750 per KL in above Consultation Paper.

MAFFFL has subsequently made presentation to AERA Authority and Stakeholders on 4th October, 2017. MAFFFL would like to submit response on following aspects impacting the tariff and request the Authority to reconsider the Tariff Assessment:

I) Loss on Sale of Fixed Assets as part of Operating Expenditure (Point no 6.6 of CP)
II) Feedback on Cost of Equity (Point no 5.2 of CP)
III) Project cost with General Purpose Borrowing Cost (Point no 4.7 of CP)
IV) Non Aeronautical Income

I) Loss on Sale of Fixed Assets as part of Operating Expenses:

MAFFFL is thankful to the Authority for accepting the Operating Expenditure including escalation of 6% year on year basis. The Operating and Maintenance Expenditure as considered by authority in proposed CP is given below:

Rs in Lakhs

S No	Particulars	FY 2016-17	FY 2017-18	FY 2018-19	FY 2019-20	FY 2020-21
A	Employee Cost	172	247	262	508	550
B	Utilities & Outsourcing Expenditure	1373	1483	1603	1732	1872
C	Repair & Maintenance Expenditure	60	64	67	71	76
D	Admin & General Expenditure	887	1321	1626	1341	1421
E	Other O&M Expenditure	209	224	239	256	273
	Total	2701	3339	3798	3908	4191

Cost element of loss on sale of asset not considered in operating expenditure.

It can be observed that loss on sale of assets is not forming part of above expenditure though it is incurred by MAFFFL up to FY 2016-17 and supported by audited accounts. The details for the same are given below:

MAFFFL has taken over the existing facilities of IOCL, HPCL and BPCL and running the fuel farm operations at CSI Airport. Simultaneously, the activities of construction of integrated facility and demolishing the specific existing facilities for creating the space for Integrated Fuel Farm are in progress. As per executed License Agreement's obligations with MIAL (please refer clause 8.3 of the License Agreement), after the Integrated Facility will be commissioned, the Redundant Facilities will be demolished and the surplus land will be handed over to MIAL for the development of the airport. Therefore, to fulfil the basic obligation under the License Agreement, phase wise accounting of loss on sale of assets is inevitable operating expenditure in corresponding accounting periods.

Loss on sale of assets incurred up to FY2016-17 is Rs 348.52 Lakhs (as per our Audited Accounts) with further estimation of is Rs 1230.88 Lakhs during FY 2018-19, totaling to Rs. 1579.40 Lakhs. The year wise break up of loss on sale of assets is given below:

Year	Rs. In Lakhs
2014-15	94.38
2015-16	254.14
Total up to 2015-16 (A)	348.52
2018-19 (B)	1230.88
Total (A) + (B)	**1579.40**

Request from MAFFFL: Please consider addition of loss on sale of assets totalling to Rs. 1579.40 Lakhs as part of operating cost in respective control periods. After considering above loss on sale of assets as part of operating cost, the year wise revised operating and maintenance expenditure is tabulated below:

S No	Particulars	FY 2016-17	FY 2017-18	FY 2018-19	FY 2019-20	FY 2020-21
A	Employee Cost	172	247	262	508	550
B	Utilities & Outsourcing Expenditure	1373	1483	1603	1732	1872
C	Repair & Maintenance Expenditure	60	64	67	71	76
D	Admin & General Expenditure	887	1321	1626	1341	1421
E	Other O&M Expenditure	209	224	239	256	273
F	Loss on Sale of Fixed Assets	348.52		1230.88		
	Total	**3049.52**	**3339**	**5028.88**	**3908**	**4191**

Other Operating Cost Observation (Land Lease Rentals)

We would like to inform that MAFFFL Board has not yet considered the increased land rental as demanded by MIAL. So far MAFFFL has managed / accommodated the land requirement of into Plane operators for their operation from the existing place. As suggested by the Authority, trued up land rentals in the third control period will be based on actual land rentals incurred during the second control period.

II) Feedback on Cost of Equity:

Cost of Equity Proposed by MAFFFL	21%
View by Authority	14%

MAFFFL would like to request Authority to reconsider Cost of Equity basis following submission:

Capital Asset Pricing Model formula basis AERA Guidelines:

As per the AERA Guidelines, Clause 9.1.3 The *Authority will estimate Cost of Equity for a control period by using Capital Asset Pricing Model (CAPM)*
Further as per clause 2.11 formula for Cost Equity is defined as below;

The CAPM model states that $Re = Rf + \beta (Rm-Rf)$
Where:
Re is the cost of equity
Rf is the risk free rate
β is the market volatility
Rm is the return on market portfolio

8/

After using above formula, estimated Cost of Equity for MAFFFL is 21.6% as detailed below;

Parameter	Basis of Assumption	Value
Risk Free Rate Rf	10 year yield for government bonds	6.50%
Market Volatility β	Unlevered β for gas transportation industry is 0.86. Using a tax rate of 34.61% and a gearing ratio of 60:40 (Debt/Equity), we have estimated the levered β for MAFFFL (please refer Explanation below)	1.70
Market Risk Rm	Past 20 years CAGR for Sensex	12.30%
Equity Risk Premiums		
A)Liquidity risk premium	The CAPM model estimates the Return on Equity (ROE) values taking into account values for listed companies. MAFFFL is an unlisted company and there is a liquidity risk for the investors. This premium is benchmarked at ~ 20%.	20%
B)Size risk premium	The β and other factors are for listed companies whose size of operations and revenue is very large compared to MAFFFL. Additionally, the growth of MAFFFL's operations is constrained due to lack of land in Mumbai. Thus generally accepted corporate finance principles suggest a benchmark size premium while evaluating ROE of small companies.	10%
Cost of Equity Re	Estimated	21.6%

Explanation for Beta:

Beta is a measure of systematic risk. Systematic risks capture the business risks of the company vis-à-vis other securities listed on the exchange. Currently there are no pure play listed fueling service providers in India. Therefore, a suitable beta value for MAFFFL's operations is considered as per the beta for gas transportation industry.

Other Premiums:

It should be noted that the cost of equity determined through the aforementioned CAPM model represents the cost for a listed entity. The securities of a listed company are freely traded compared to an unlisted company (MAFFFL). Thus widely accepted corporate finance principles suggests that in case of an unlisted company, **a liquidity risk premium should be considered which is ~ 20%.** Similarly, the size of MAFFFL operations is small compared to the listed companies (such as GAIL) who have been considered as a benchmark for Beta estimation. Thus we have considered an **additional size premium of ~ 10%.**

With above formula, as per the AERA Guidelines, the cost of equity is estimated at 21.60%. The detailed computation is enclosed in **Annexure 1**.

Additionally, following factors also support Higher Cost of Equity:

- Higher risk profile mandates higher expected return on equity
- Volatility in Aircraft Movements
- Fuel is a dangerous good hence fuel storage & handling involves various security & safety procedures as well as several risk aversion systems
- Airport being a vulnerable area (high risk area), providing an essential service (into dangerous goods) possess an additional risk
- Dependence on Airport Operator for utilities and other complementary services, thus any failure by Airport Operator in providing the same would directly impact MAFFFL's operations
- Execution of Integrated Fuel Farm project at the brownfield airport will require more precautions/clearances from various regulatory agencies and may result in hindrance in project execution.
- Aviation being very sensitive industry, natural disasters in not only India but in other countries also
- With Navi Mumbai Airport development, it possesses traffic risk at existing airport thereby resulting in lower recovery.

Higher risk profile mandates higher expected return on equity. However, vide point no 5.2 of the CP, the Authority has considered the cost of equity at 14%. MAFFFL believes that 21.60% Cost of Equity is justified in above stated environment and business conditions and requests Authority to reconsider the cost of equity.

Debt Equity exposure of MAFFFL:

MAFFFL has considered Debt Equity Ratio as 60:40. Further, HDFC has sanctioned Rs 350 Crs as long term loan to MAFFFL.

Basis above, FROR proposed by MAFFFL is 15.24% and considered by the Authority at 11.87%.

Request from MAFFFL: Please consider Cost of Equity at 21.60% based on Capital Asset Pricing Model formula given in AERA Guidelines. Rate of cost of equity higher than proposed rate of 14% by Authority will help MAFFFL to improve its FROR above 11.87% Due to higher debt exposure and risk factors stated above, MAFFFL requests Authority to consider greater than 14% rate for cost of equity.

III) Total Project Cost:

The comparison of project cost as worked out by MAFFFL and as proposed by Authority is given below:

Rs in Lakhs

Particulars	**As per MAFFFL's Submission**	**Proposed by Authority**
Total Capex cost (A)	**68354**	**68354**
General Purpose Borrowing Cost	1925	
Interest During Construction	1242	
Financing Allowance		1879
Total (B)	**3167**	**1879**
Project Cost (A) + (B)	**71521**	**70233**

MAFFFL is thankful to the Authority for considering total capex cost in CP basis the MYTP submitted by MAFFFL. Further, MAFFFL would like to submit following:

MAFFFL capitalised General Purpose Borrowing Cost based on IND AS Accounting Principles.

- Under IND AS 23, borrowing costs incurred in relation to both specific and general borrowing are required to be considered for inclusion in the cost of the qualifying assets.
- Accordingly, for each period, the Company is required to determine value of general borrowing cost for the respective period and determine the amount of general borrowing cost to be capitalized for specific project.

Basis the above, MAFFFL has accounted for the General purpose borrowing cost of Rs 1925 lacs and capitalized the same for the period of construction. Additionally, interest during construction of Rs 1242 lacs was also capitalised by MAFFFL.

Observation: The Authority vide point 4.7 of CP has excluded General purpose borrowing cost and only considered financing allowance as per clause 9.2.7 of the CGS guidelines as part of RAB.

Request from MAFFFL: Please consider General Purpose Borrowing cost in addition to Financing Allowance as part of project cost.

IV) Non- Aeronautical income

MAFFFL has generated dividend / interest on fixed deposits out of investment of the surplus funds.

- Surplus funds are generated through cost effectiveness measures, basically placed as an interim arrangement in Fixed deposits/liquid funds to generate extra income before funding the project.

- These surplus investments are result of constant monitoring of cash flows and optimum utilization of cash required for operations and project.

- This requires efficient treasury management.

Request from MAFFFL: Request Authority to consider Fuel Infrastructure Charges as Income under Aeronautical Revenue and other above incomes as Non-Aeronautical income as these are Non-Aeronautical in nature.

Trust you will find the above submission in order.
Thanking you.

Yours Sincerely,
For Mumbai Aviation Fuel Farm Facility Private Limited

Geeta Iyer
Chief Financial Officer

Annexure 1: Computation of Cost of Equity

The CAPM model states that Re = Rf + β (Rm-Rf)
Where:
Re is the cost of equity
Rf is the risk free rate
β is the market volatility
Rm is the return on market portfolio

1) RF = 6.5%

2) The formula for β is
levered beta = unlevered beta * (1+ (1-tax rate) (Debt/ Equity))
In case of MAFFFL, **levered beta = 0.86 * (1+ (1- 34.61%)*(1.50)) = 1.7**

3) Return on Market Portfolio 2.30%

4) Cost of Equity (Re) without Equity Risk Premiums is
Rf + B (Rm – Rf)
6.5 + 1.70 (12.30 -6.5) = **16.36**

5) Cost of Equity (Re) with Equity Risk Premiums

Cost of Equity without Equity Risk Premium as calculated above = 16.36

Liquidity Risk Premium = 20%

Cost of Equity = 16.36 * 1.20 = 19.63

6) Cost of Equity (Re) with Equity Risk Premiums

Cost of Equity without Liquidity Risk Premium as calculated above = 19.63

Liquidity Risk Premium = 10%

Cost of Equity = 19.63 * 1.10 = 21.60