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Menzies Aviation (India) Pvt. Ltd.

Date: 23rd December, 2010

Cargo Terminal 1
Plot No. C-04 L
Bengaluru International Airport
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To,
Mr. Sandeep Prakash,
Secretary AERA
AERA Building,
Administrative Complex,
Safdarjung Airport, New Delhi 110003

Dear Sir,

At outset I would like to thank you and Mr. Yashwant Bhave, Chairman, AERA for meeting us on 9th Dec'10. Subsequent to our meeting it was proposed by Mr. Ian Gibbons, deputy director UKTI to send our technical explanation to you in writing. Please find attached our representation detailing reasons for using return on investment as measure to control tariff rather than fair rate of return on regulated asset base.

We also appreciate AERA's willingness to hear stakeholders like us and having given us the opportunity to bring our points in this important technical matter.

We operate as Joint Venture in Hyderabad and since we discussed Hyderabad cargo terminal we have to take our joint venture partners input that has resulted in delay in writing to you.

We request you to take these technical point on board in applying price cap approach to stations which do not qualify for light touch regulation because proposed guidelines per consultation paper no.5 not only have high profitability impact on our business but also brings price inconsistencies in the market place with respect to introducing competitor in same station and neighboring stations.

In case of further requirement of discussions or explanation on this technical paper, I will be pleased to make myself available.

Thanking you

Yours Sincerely

Prashant Nimgade
Vice President Finance
Menzies Aviation (India) Pvt. Ltd

cc : Mr. Yashwant Bhave, Chairman, Airports Economic Regulatory Authority of India



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Return on Investment and Return on Depreciated Asset Base

Return on Investment: Return on investment measures the profits that are made out of total capital investment. A project will never be undertaken if it does not give returns that satisfy minimum criteria of returns expectation based on risk profile of the project. Once these profit levels are determined for the company, the backward calculation gives the price per unit that can be offered in the market place. This is purely investment decision and reflects the project risk. We believe that it is this price that AERA should regulate and not return on equity.

This investment can be funded either by Debt or Equity in various proportions which is purely a financing decision. Irrespective of how the investment is funded the capital investment for a given project will be same and it is this capital investment and expectation of profits based on risk that determines the price to be offered in the market place. If this capital is overspent or excessive company profits are expected then prices will be higher and the company as whole is either inefficient in market or overpricing its products. This resultant under (overspent) on capital and company profit decision are linked to risk of project and not funding of the project. Hence investment decision and financing decisions are independent of each other.

Below is example of a project which requires INR 1000 of capital and project investment earns a company profit of INR 80 (8% return on investment). Cost of debt is 12% and 80% of the capital is funded by Debt.

As we can see, the company profit as percent of investment is fixed across all 8 years but return on equity increases over same period. Also note in initial years return on equity is zeroed out since company cannot service debt at the level at which profits are realized implying that either Promoter defaults on the lender or pumps in fresh equity to service debt. In short, higher the debt higher the risk of default risk promoter faces. Also note that this default risk is solely of promoter because of choice of funding arrangement. In order to compensate for this default risk, promoter gets compensated in later years by making returns in excess of 10%-34%.

Secondly debt is not freely available as promoters are often required to offer collateral for borrowing from lenders. Promoters have to pledge certain assets which can never be reused during the tenure of loan period. There is opportunity cost of this collateral that is captured in the equity returns excess of cost of debt in funding arrangement.

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Illustration Balance Sheet of Company funded by Debt and Equity								
INR	1	2	3	4	5	6	7	8
Shareholders Fund & Liability								
Equity (E)	200	200	200	200	200	200	200	200
Debt (D)	800	700	600	500	400	300	200	100
Reserves (R)	-116	-120	-112	-92	-60	-16	40	108
	884	780	688	608	540	484	440	408
Fixed Assets (FA)	1000	1000	1000	1000	1000	1000	1000	1000
Depreciation Cumm	100	200	300	400	500	600	700	800
Net Book Value (RAB or NBV)	900	800	700	600	500	400	300	200
Current Assets								
Cash from Depreciation	0	0	0	0	0	0	0	0
Cash from Profits less Interest	-16	-20	-12	8	40	84	140	208
Total Assets	884	780	688	608	540	484	440	408
Debt Repayment	100	100	100	100	100	100	100	100
Company Profit	80	80	80	80	80	80	80	80
Interest Portion (Rd)	96	84	72	60	48	36	24	12
Equity attributable Profits (EP)	0	0	8	20	32	44	56	68
	Ratios							
Re	0.0%	0.0%	4.0%	10.0%	16.0%	22.0%	28.0%	34.0%
Rd	12.0%	12.0%	12.0%	12.0%	12.0%	12.0%	12.0%	12.0%
Company Profits/Investment	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%

Please note below how the return on equity changes for various levels of debts in the company. Higher the debt, higher the risk of default promoter faces and hence gets compensated accordingly. The promoters cannot off-load this default risk to market or customers because each company has different debt equity structures.

	Return on Equity (Re) for 8% return on investment]							
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8
10%	7.6%	8.9%	8.9%	8.9%	8.9%	8.9%	8.9%	8.9%
20%	7.0%	8.5%	10.0%	10.0%	10.0%	10.0%	10.0%	10.0%
30%	6.3%	8.0%	9.7%	11.4%	11.4%	11.4%	11.4%	11.4%
Debt percentage								
40%	5.3%	7.3%	9.3%	11.3%	13.3%	13.3%	13.3%	13.3%
50%	4.0%	6.4%	8.8%	11.2%	13.6%	16.0%	16.0%	16.0%
for fixed 8% return								
60%	2.0%	5.0%	8.0%	11.0%	14.0%	17.0%	20.0%	20.0%
70%	0.0%	2.7%	6.7%	10.7%	14.7%	18.7%	22.7%	26.7%
80%	0.0%	0.0%	4.0%	10.0%	16.0%	22.0%	28.0%	34.0%
90%	0.0%	0.0%	0.0%	8.0%	20.0%	32.0%	44.0%	56.0%

(Reproduced from our response on 15th Sept'2010)

Regulated Asset Base: Per Sec 8.2.2 of Guidelines, AERA has defined Regulated Asset Base as net investment made by ISP's. RAB is depreciated every year with fair rate and taken average of before taking FRoR percentage on it as profit. We think this treatment is incorrect for following reasons;

- a) Depreciated RAB Vs Un-depreciated RAB: RAB estimated net of depreciation mixes up the economic measurement of business profitability with accounting measure of profitability.

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In short, using depreciated RAB does not correctly yield Re on equity as apparent in the 100% equity funded table above, the return on Equity never really reaches agreed Re.

Another widely accepted concept for measuring fair rate of return is return on Capital Employed. In this measure all the undistributed cash, including surplus and working capital, is expected to earn the same return as equity. Using depreciated asset method gives ROCE which is not even closer to estimated FRoR.

Same illustration can be extended to debt and equity funded ISP as illustrated below;

	Balance Sheet of 50% Debt and 50% Equity Funded ISP							
	1	2	3	4	5	6	7	8
Shareholders Fund & Liability								
Equity (E)	500	500	500	500	500	500	500	500
Debt (D)	500	400	300	200	100	0	0	0
Reserves (R)	61	198	327	434	533	720	794	844
	1061	1098	1127	1134	1133	1220	1294	1344
Fixed Assets (FA)								
Depreciation Cumm	1000	1000	1000	1000	1000	1000	1000	1000
Net Book Value (RAB or NBV)	100	200	300	400	500	600	700	800
Current Assets								
Cash from Depreciation	900	800	700	600	500	400	300	200
Cash from Profits less Interest	0	0	0	0	0	100	200	300
Total Assets	161	298	427	534	633	720	794	844
	1061	1098	1127	1134	1133	1220	1294	1344
Repayment	100	100	100	100	100	0	0	0
	Ratios							
Re	36.0%	36.0%	36.0%	36.0%	36.0%	36.0%	36.0%	36.0%
Rd	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%	12.5%
D/(D+E)	50%	44%	38%	29%	17%	0%	0%	0%
W _e	47%							
FRoR	25%	25%	25%	25%	25%	25%	25%	25%
Profit = FRoR X RAB	224	199	174	149	124	99	75	50
FRoR = Profits/RAB	25%	25%	25%	25%	25%	25%	25%	25%
Profits/Investment	22%	20%	17%	15%	12%	10%	7%	5%
ROACE = Profits/Capital Employed	21%	18%	16%	13%	11%	8%	6%	4%

Based on above two illustration, it is clear that using depreciated value does not serve the purpose of ensuring Fair Rate of Return is achieved, hence we recommend that RAB should be un-depreciated asset base over the entire control period.

If the same table is worked on the un-depreciated RAB the Re each year will be same at 25% which will be agreed with AERA.

AERA should look at other parameters like Return on Capital Employed after tax (ROACE) as this is widely accepted concept and guarantees fair return to investors.

- b) Table below shows impact of using un-depreciated asset for FRoR and depreciated RAB on our project investment evaluation on hypothetical numbers. All the project finance investments by sponsors like us look at the non depreciated asset base for calculating the profitability³.

³ Teresa De Lemos, Martin Betts, David Eaton and Luis Tadeu De Almeida, "The Nature of PFI", Spring 2003, Journal of Structured and Project Finance.

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Impact on Project Investment Returns						
FRoR	25%					
Cash Flows assumptions at the time of Investment						
	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Cash Outflow						
Capital	-1500					
Cash Inflow						
Profit		375	375	375	375	375
Depreciation		500	500	500	0	
Total Cash Flows	-1500	875	875	875	375	375
IRR	43%					
Cash Flows assumptions CHANGED due to AERA method						
	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
Cash Outflow						
Capital	-1500					
Cash Inflow						
Profit		375	313	188	63	
Depreciation		500	500	500	0	
Total Cash Flows	-1500	875	812.5	687.5	62.5	
IRR	29%					

- c) RAB approach brings Price differential for same service: We are service providers at Greenfield airport, by using the RAB approach we are at disadvantaged in initial years as our prices will be 27% higher at same volume level Recognizing the fact that Brownfield airports already attract more volumes than us the difference in yield will be close to 50% assuming double volume level. See illustration below:

Illustration:

ISP2 is a Brownfield service provider who has been in operation for last 5 years and Tariff Year 1 happens to be sixth year of operation.

ISP1 is a Greenfield service provider who has started the operation a year ago and just capitalized his assets. ISP 1 is in second year of operation and Tariff year 1 of Multi Year tariff period

For simplicity all other costs and taxations are assumed same and also volumes are assumed same although volumes at brown field are likely to be higher, we are ignoring it here.

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Two Service providers with same investments but different starting points						
ISP1: Profitability of New Service Provider at Greenfield Airport						
Particulars INR'000		Tariff Year 1	Tariff Year 2	Tariff Year 3	Tariff Year 4	Tariff Year 5
Year of Operation		2	3	4	5	6
RAB for calculating ARR	RAB	800,000	720,000	640,000	560,000	480,000
Depreciation (Life 10 years)		80,000	80,000	80,000	80,000	80,000
Fair Rate of Return	FRoR	25%	25%	25%	25%	25%
Profitability	RAB*FRoR	200,000	180,000	160,000	140,000	120,000
Costs	O-D-T	100,000	100,000	100,000	100,000	100,000
ARR		300,000	280,000	260,000	240,000	220,000
Tonnages		100,000	100,000	100,000	100,000	100,000
Yield at ISP1 (INR/Kg)		3.00	2.80	2.60	2.40	2.20
ISP2: Profitability of Service Provider at Brownfield Airport						
Particulars INR'000		Tariff Year 1	Tariff Year 2	Tariff Year 3	Tariff Year 4	Tariff Year 5
Year of Operation		6	7	8	9	10
RAB for calculating ARR	RAB	480,000	400,000	320,000	240,000	160,000
Depreciation (Life 10 years)		80,000	80,000	80,000	80,000	80,000
Fair Rate of Return	FRoR	25%	25%	25%	25%	25%
Profitability	RAB*FRoR	120,000	100,000	80,000	60,000	40,000
Costs	O-D-T	100,000	100,000	100,000	100,000	100,000
ARR		220,000	200,000	180,000	160,000	140,000
Tonnages		100,000	100,000	100,000	100,000	100,000
Yield at ISP2 (INR/Kg)		2.2	2.0	1.8	1.6	1.4
ISP2 Rates Cheaper than ISP1		27%	29%	31%	33%	36%

This disparity in prices charged by ISP's is significant enough for agents to move their cargo to lower priced handler. ISP1, despite AERA allowing higher FRoR, will never be able to charge higher rate and make FRoR allowed by Authority. ISP1 will end up reducing the price and hence lower its profit to sustain its volume. Understandably, this situation exists under current market conditions but ISP1 has scope to recover its downside in subsequent years due to possible higher volumes. ISP1 charges will be further reduced by AERA to compensate for upside in previous years. Per AERA's proposal, an effect in downside is same but upside is capped to the extent of predetermined FRoR. This approach discourages new investment and also penalizes any improvements in infrastructure.

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- d) RAB versus Capital cost at Sea ports: Please refer to Tariff Authority of Major Ports notification issued by Government of India in the Ministry of Shipping, Road Transport & Highways under section 111 of the Major Port Trust Act 1963, communication No.PR-14019/25/2007-PG dated 12 February 2008, section 3.4.1. This guideline also allows Capital Cost and not depreciated asset value as base for multiplication with the Return on Capital Employed per section 3.7.1. We therefore believe that RAB should be taken at cost basis and not depreciated basis (Reference 1).