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299



14<sup>th</sup> September, 2010.

Shri Sandeep Prakash  
Secretary  
Airport Economic Regulatory Authority of India (AERA)  
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15/09/10  
OSD-I

SM (ARBS)  
→ PWC

15/09/10

**Ref: Consultation Paper No.05/2010-11 on Economic Regulation for Services Provided for Cargo Facility, Ground Handling and Supply of Fuel to the Aircraft**

Dear Sir,

We are hereby submitting our response to the above document for your kind perusal.

In view of the complexity of the detailed submission, we would be more than happy to take you through the submission in person.

Thanking you

Yours Sincerely

  
Paul Smith  
Chief Executive Officer

CC: Yashwant Bhawe, Chairman, AERA

300



**Menzies Bobba Ground Handling Services Pvt. Ltd.**

Response to

Consultation Paper No.5/2010-11

of

Airport Economic Regulatory Authority of India

on

Economic Regulatory Services Provided for

Cargo Facility,

**Ground Handling &**

Supply of Fuel to the Aircraft

**15<sup>th</sup>, September 2010**

301

**Index:**

<b>1.0</b>	<b>Executive Summary</b>	<b>3</b>
<b>2.0</b>	<b>Introduction</b>	<b>5</b>
<b>3.0</b>	<b>MBGH Position on Proposed AERA philosophy</b>	<b>6</b>
<b>3.1</b>	<b>Need of Regulation under Current Business Environment</b>	<b>7</b>
<b>3.2</b>	<b>Materiality Criteria</b>	<b>11</b>
<b>3.3</b>	<b>Competition Criteria</b>	<b>13</b>
<b>4.0</b>	<b>MBGH Position on Proposed AERA Technical Guidelines</b>	<b>16</b>
<b>5.0</b>	<b>Possible Impact on Trade</b>	<b>31</b>
<b>6.0</b>	<b>Discrepancies in Consultation Paper no.5</b>	<b>33</b>
<b>7.0</b>	<b>Our Recommendation</b>	<b>34</b>



302



**1.0 Executive Summary**

AERA has issued consultation paper no.5, per Section 15 of AERA Act 2008, giving directions for determination of tariff for aeronautical services under the areas of cargo handling, ground handling and fuel farm. Menzies Bobba Ground Handling Services Pvt. Ltd. hereafter also referred as 'MBGH' is a ground handling company and is directly affected by the regulation being formulated by AERA.

We have reviewed the consultation paper including such areas as philosophical approach, concept of materiality, definition of competition and the technical mechanism behind tariff regulation. Our position has been articulated in different sections of our response.

When MBGH bid for the project and made investments subsequent to being awarded the license, we were not aware of any tariff regulations being brought in at least during the life of our concession term. MBGH is bound by the signed Concession Agreements with Airport operator. Our shareholders, both local and overseas, invested based on these agreements, market conditions, which offered free price mechanism. Any change to existing market conditions will make companies less willing to invest and the new regulations may have a detrimental effect.

At the time of investment we were given the clear impression that domestic airlines will also form part of our volume scope on the back of Government's new Ground Handling policy that was to have been brought into effect from 01Jan, 2009. For Greenfield Airports, this should have already taken off at the commencement of new airport operations.

Handling services around the world in general are offered in openly competitive ways. In the few instances where there is regulation, the terms of such regulation are clear at the time of service providers making the investment, so that it could be considered in the economic profile associated with the investment. We believe that the prospect of new regulation at this later juncture, particularly if it is a heavy regulatory regime will likely harm businesses like ours that have taken the risk and already made substantial commitments to improving the Indian aviation infrastructure. As such, any heavy regulation may damage the reputation of India as an attractive market and the prospect of securing additional competition into the country. In this way, regulation may actually be inimical to increased competition into the future.

Current business environment is on a B2B basis with the airline customers having a strong bargaining power in terms of acceptable tariff. Need for a third-party regulating tariff isn't necessary under prevailing business conditions. Proposed complex tariff regulation doesn't exist anywhere in the world for ground handling sector. Our present tariff is comparable and even better than past service providers, while the level of investment and service efficiency is of a much superior level.



303



Given our world class ground handling service offering and the extra services we deliver per international norms, our tariff to airlines is competitive.

AERA has prescribed threshold level 5% for ground handling services but not provided benchmarks for the suggested limits. Keeping in mind the nascent stage of the industry, AERA should increase the threshold for materiality up to 10%.

We believe that competition is the best way to secure the fairest deals for all businesses involved at an airport or in logistics. Moreover, our existing value proposition to our customers has already been and continues to be shaped by substantial competitive processes that do not appear to be considered by the envisioned control methods. Competition began at the outset with the Airport Operators' robust tender program with many of our international competitors participating. As part of those tender processes, the Airports introduced the requirement that upon reaching certain threshold, additional service providers would be brought to the airports. Competition criteria in our assessment should consider two players as there is enough evidence to suggest that two players in a market offer required competition.

We have reviewed the technical aspects of AERA's consultation paper in detail and have commented on important elements, which require a careful rethink.

We have also listed possible impact of proposed regulation for trade and its consequences.

Despite having detailed the current scenario and commenting on AERA's proposal draft, were AERA to proceed in its process to regulate tariff following our recommendation would be for a 'Light Touch' approach. One way of doing it is based on benchmarking wherein the tariff of all service providers for a particular service is benchmarked.



304

## 2.0 Introduction

AERA, hereafter also referred as 'Authority' has issued consultation paper no.5, per Section 15 of AERA Act 2008, giving directions for determination of tariff for aeronautical services. The consultation paper details the proposed tariff regulation of service provided at cargo facility, ground handling facility and supply of fuel to the aircraft. MBGH welcomes the opportunity given to the stakeholders for their contribution in the consultation process. We are pleased to comment on the consultation paper on the overall philosophy, approach and technical details for regulating the aforesaid services.

We recognize and compliment AERA's effort to ensure transparent process, per Section 13(4) of the AERA Act, in the process leading up to the framing of appropriate procedures and systems for economic regulation.

- We acknowledge that per the definition of the Independent Service Providers, hereafter referred as 'ISP', MBGH is covered under this consultation paper and that it directly affects our business and tariffs. Also that we are not airport operator providing Ground Handling services and therefore will not come under regulation that AERA proposes to bring separately.
- AERA, proposes to regulate the tariff that ISP's charge to the Airlines per section 13(1)(a) of the Act.
- AERA recognizes that service level agreements between ISP's and Airlines are acceptable forms of safeguards for quality of service received by Airlines. AERA does not want to link the tariff to service parameters, which are influenced by multiple party interdependencies like on time performance, safety compliances, operations service delivery, information requirement etc. In future, AERA proposes to determine a system for monitoring performance standard.
- AERA proposes *Materiality* and *Competition* Assessment to determine applicability of regulation to ISP. Based on materiality and competitiveness an ISP faces either a Price Cap approach or a Light touch approach.
- Pursuant to Section 15 of the Act, AERA has issued detailed guidelines for arriving at Tariff by taking into consideration Fair Rate of Return on Regulated Asset Base and other technical parameters.





305

### 3.0 MBGH Response to Proposed AERA philosophy

MBGH was asked for its input by our airport operator in the month of March 2010 regarding AERA's role in ground handling and we had accordingly responded. Our input to the airport operator's response to AERA is briefly stated below.

- Competitive assessment made in respect of concessionaires and operators in the field of ground handling needs to be expanded to cover:
  - Selection of the concessionaire through a competitive process.
  - Comparison of charges in other similar airports having adequate competition. For example, in small airports like HYD where volumes are relatively less, it is not economically viable to have more than two ground handlers and that too in a situation where the Ground Handling policy has been time and again postponed. If increased, for the sake of having more providers, it will lead to large scale duplication of infrastructure beyond minimum economic levels in a market where the current handlers aren't doing financially well. Introduction of a third handler has been defined in the concession agreement but we believe its parameters have to be changed in light of the fact that Ground Handling policy hasn't and may never see the light of the day.
- In order to ensure the continued viability of operations of airport services for the investors, it is our strongly held view that adherence to concession agreement and bid assumptions is necessary, which also considers implementation of Ground Handling policy. All agreements including concession agreement, State support agreement etc. entered between Airport Operators and Independent Service Providers should be considered. Similarly, all reasonable bid assumptions taken by the bidders for such services in the absence of certainty must be considered not only for the first review period, but for the entire tenure of the agreement.
- All benefits/ concessions offered to the investors of ISP as part of sub-concession agreement, state support agreements and other such agreements needs to be considered.
- The Authority must adopt an objective approach towards service quality, while recognizing the key linkages between airport operating conditions, service quality, operating expenses and capital expenditure and ensuring that only those parameters that cause material impact on cost of stakeholders be considered.
- Rigid and intrusive regulation will shy away the potential economic development in this sector, which has suffered a dent due to non-implementation of Ground Handling policy.

306

Our point of view hasn't changed since and we continue to believe that market forces are very active and determine competitive tariffs to be charged.

Subsequently, we have received AERA consultation Paper No.05 dated; 02August'10 and MBGH would like to submit to Authority our point of view on the proposal draft.

### **3.1 Need of regulation under Current Business Environment**

**3.1.1** Tariff setting and regulation is a complex process and difficult to have one, which everyone will consider to be fair and equitable. Indian and international companies make investment decisions for competitive tenders based upon promises and regulations at a particular time, with an expectation of a level of return on that investment. There is a level of risk in the investment which companies try and assess before they make the investment. If regulations are unexpectedly imposed to cap the level of returns for existing investments then companies will be far less willing to invest in the future, as there will be an increased but unquantifiable risk. This will be counterproductive, as it will stifle competition for the future and lead to less investment in the sector. Companies expect a clear and level playing field at the time of making a capital decision. Therefore, it would make sense if any rules were put into place it should apply for future investments, but not to past investments.

Some investments fail and some make returns in excess of what may have been envisaged at the time of original investment. Sometimes there are losses in one year of a contract but better profits in other years. In HYD, MBGH's profitability and economic viability is severely dented due to non implementation of Ground Handling Policy. Capping returns on the successful projects or the best years, while still leaving the risk of failure, distorts the competitive model and increases the risk of investment decisions. Again, this will make companies less willing to invest and the rules may have a detrimental effect.

MBGH is bound by the signed Concession Agreements with Airport operator. Our shareholders, both local & overseas, invested based on these agreements, market conditions, which offered free price mechanism and opening of the market with Ground Handling policy. At the time of tendering process, reference was made to the concession agreement between Government of India and Airport operator, which did not include regulation of ground handling services. Introducing tariff regulation now is in conflict with the above concession agreement, which had influenced our decision making.

We have already brought in international operating standards for the benefit of the Airlines, which are much superior in nature compared to that offered by earlier service providers. These include such features as new handling equipment, key focus on safety elements and practices, environment care, better labour practices etc. The tariff control regulation approach by



307



Authority will be a fundamental change to the economic environment so much as we see this move as going from free market situation to a complex regulated one. It may sound surprising that we do not support tariff regulation in its proposed form as it may work better for us since in initial years guaranteeing some returns linked to investments and which we currently don't make. Much as it appears to be a tempting proposition, it is not so, we are nevertheless committed to operate in a free market economic environment. This is a key business value our organization believes in.

We were selected after international bidding process. Our concession agreements have inbuilt clauses that prevent any exploitation of market situation by bringing in more handlers. New handlers would be allowed when market volumes justify new entrants.

**3.1.2** We believe that AERA if implemented will bring in lot of uncertainty to the existing functioning of ground handling operations. Our nature of business is such that we are prone to higher external risks which are beyond our control. Recession in Aviation Industry in 2008-09, natural calamities like Volcanic Eruption in May 10 etc., airlines going into bankruptcy, etc., have the scope to severely dent our revenues and profitability.

**3.1.3** There is so much of uncertainty in built into our business as our clients who are basically Airlines do operate to Hyderabad based on the passenger load volumes. If the Airlines could not break even their costs on account of poor passenger factor they discontinue their operations. Classic case will be KLM, Sri Lankan, Kuwait Airways, Singapore Airlines and Gulf Air who stopped their services for more than a year on the backdrop of poor passenger load. Investments were already made by the handlers in Hyderabad and these suffered as there was no substitute volume available.

**3.1.4** ISPs do not deal with general public directly and therefore can not enforce tariff as they please. Our business is on B2B basis where the customers have strong bargaining power to achieve desired rates. Under the B2B model, tariffs are agreed after hard negotiation, which includes defining & determining expected service levels and pricing. Under two party business to business negotiation scenarios, Authority's attempt to control tariff arbitrarily only weakens the negotiation power of ISP and Airlines.

**3.1.5** At the time of investment MBGH did not factor in Tariff control regulation after three years of investment decision and two years of operation. In general, all the international and some national<sup>1</sup> projects which are under Public Private Partnerships, Tariff control regulations

<sup>1</sup> Tariff Authority for Major Ports, G.No27 Delhi, 26 February 2008, Guidelines for upfront tariff setting for PPP projects at Major Port Trusts, 2008, section 1.3.1



308

are clarified at the time of award of concession or before investments are made, thereby giving fair assessment of economic environment to potential investors.

**3.1.6** MBGH does not have off-take contracts with customer which is a well known feature of PPP projects hence in this case we bear the volume risk. This is evident from the fact that during 2008 and 2009 we suffered revenue reduction of 64% compared to forecast, primarily due to Ground Handling policy not being implemented. Therefore this type of PPP project can only be compared to toll road projects where sponsors face similar volume risks.

Examples of Toll Road Projects; a) Poland's A2 Motorway, awarded in 1997 to Autostrada Wielkopolska, S.A.(AWSA), b) San Isidro, Latin America, Route 13 awarded in 2000 to LCA Construcciones. However, in these PPP awards two elements were distinct, both had a regulation mechanism defined at the time of award of the concession and both had light touch approach<sup>2</sup>.

**3.1.7** Upon verifying with our international shareholder, Menzies Aviation Plc, who is one of the largest global Cargo and Ground Handler having operations in 112 stations, 27 countries across 5 continents, we found that in general, the tariff control regulation mechanism envisioned here does not exist in any part of the world. There are two exceptions to the rule and these are in very small stations of Dakar (in Senegal) and Santo Domingo, Puerto Plata (in Dominican Republic) but in those two locations there is no more than a light touch approach.

Overview of tariff regulation where Menzies Aviation operates can be found in the below table.

Region	Status on Tariff Regulation	Remarks
North America	No tariff regulation	Applies to station where Menzies is the exclusive handler as well as where the size of the airport draws multiple competitors.
South America	No tariff regulation except in Dominican Republic (DR) – Santo Domingo (SDQ) and Puerto Plata (POP).	Government has put in place a tariff but is not based on any formulas related to Fair Rate of return. It is done on adhoc published rate Further, there are exclusive GH operations in all 3 Caribbean Stations - SXM POP SDQ - there are many similar platforms

<sup>2</sup> <http://www.people.hbs.edu/besty/projfinportal/>

309

		throughout the Caribbean and Latin America
Europe (minus UK)	No tariff regulation	Applies to exclusive operation situation as well. In some European airports often one handler is active. For e.g. in Rotterdam, Avia Partner has a license, there is no tariff regulation and the airport does not allow a second handler because of low volumes.
UK (Menzies home market)	No tariff regulation	Applies to exclusive operation as well.
Africa	No tariff regulation except in Senegal, Dakar(DKR)	Government has put in place a tariff but is not based on any formulas related to Fair Rate of return. We are a sole supplier of handling and cargo services in Cotonou (Republic of Benin), Niamey (Republic of Niger) and Bangui (Central African Republic) all without price regulation or tariff.
Australia , New Zealand	No tariff regulation	Applies to exclusive operation as well.
China (minus Hong Kong and Macau)	Yes but with a different logic	There are regulated handling charges based on Article 159 of CAAC document. The regulated tariff only restricts the handling charge of domestic flights but not international flights. Basically, the Government is using ground handling charges from handling international flights to subsidize the charges on domestic flights. Most of PRC domestic airports do not have sufficient international flights. So, government owned



310

		ground handling companies continue losing money but then are funded by the Government. Here again the regulated tariff is not based on any formulas related to Fair Rate of return.
Hong Kong and Macau	No tariff regulation	Macau has one exclusive single handler doing both cargo and ground handling.

Note: In the middle-east there are examples that we know of like Dubai (DNATA), Abu Dhabi (ADAS), Bahrain (BAS), Oman, Sharjah, Ras-al-Khaimah that we can think of, which are exclusive operations but do not have tariff regulation.

**3.1.8** MBGH current tariff, in general, is similar or even better to historical tariff charged by earlier operators notwithstanding, comparatively higher investment, increased operating costs, best facilities of international standards etc. made by us against a limited concession term.

**3.1.9** The ISPs have brought in the efficiencies in the Aeronautical service economics, which has been largely acknowledged by one and all from the industry. MBGH believes there is strong co-relation between the calibre of service provided and price charged for the same. Whereas AERA is confident of the Service Level Agreements between ISPs and Airlines, it is ignoring the right of price determination by ISPs for the same service standard. AERA is now bringing the Tariff control and subsequently will bring the procedure for monitoring the performance standard, which isn't a correct way especially when the two are clearly inert-related. Per Section 13(1)(d), AERA ought to monitor the set standard of quality provided, there is disconnect in timing between control of pricing and monitoring the services quality.

**3.2 Materiality Criteria**

Materiality assessment criterion is arbitrary and there is no basis to limit it to 5% of major airport volumes handled at the airport. Materiality cannot be measured in terms of volume alone. Aircraft volumes at a particular airport depends upon various factors including local state government policies, economic growth, demographic profile, size of catchments areas, etc. and are not the same for any two airports. For Greenfield operations like MBGH where investment in infrastructure is high and concession period is short, the Materiality criteria should be higher especially when not many Airlines operate to these destinations.



311

In our opinion materiality assessment should consider following aspects:

- Size of market
- Investment levels
- Timing of investment
- License period for recovery

Like any infrastructure facility, Ground handling investments needs to be built for a minimum scale to justify operational efficiency and future growth considerations. Expansion of terminal capacity based on incremental volume growth isn't a feasible exercise. It has to be done in phases with the first phase catering to current and future volumes. Only after certain growth is achieved, one will develop further capacity to the next level of growth. Accordingly, to achieve operational efficiency and to optimize throughput, our investment has been made to an optimum capacity but at the moment it does not operate to desired levels, primarily due to Ground Handling policy not being implemented.

The scale of operations driven by performance criteria defines the amount of investment. Government had shown a vision of developing an international level facility as available in developed nations. Accordingly shareholders of MBGH, under JV arrangement, have jointly invested significant sums to develop the operations. The investment was made in single instance during 2007 with the JV license valid for 7 years. While assessing 'Materiality' it is important to consider the level of investment vs. expected throughput levels vs. length of the concession period.

Hyderabad Traffic volumes are a fraction of other metro volumes but at the same time it has more than proportionate number of handlers. These handlers have to provide better service standards than others. Very recently Hyderabad airport was voted as the no. 1 airport in the world and we as ground handler at the airport have contributed our bit for the Airport to achieve its coveted recognition. This fact must be given its due consideration.

AERA has prescribed threshold level 5% for ground handling services but not provided benchmarks for the suggested limits. Keeping in mind the nascent stage of the industry, AERA should increase the threshold for materiality up to 10%.

We therefore request a higher threshold for Materiality index for ISP's at Greenfield airports.

312

### 3.3 Competition Criteria

Guideline defines more than two providers at a station as competition. We would like to bring to the kind notice that in the consultation paper on "Regulatory Philosophy and Approach in Economic Regulation of Airports and Air Navigation "Facilities", dated\_26<sup>th</sup> February 2010, under section 2.13 the Authority noted:

*"Consistent with the Authority's overall regulatory approach outlined above with respect to regulation of tariff / end user charges for cargo facilities, ground handling services and fuel farm / access facilities, the Authority proposes to presume a degree of competition wherever **two or more** cargo facilities are operational at airports. In such cases, the Authority proposes to approve tariffs based on submissions with respect to **broad level justification** by the operators."*

We agree with the assessment made in the above text that competition would be adequate with their being two service providers at an airport.

Further, we believe competition should be assessed based on following parameters;

- Number of same service providers such that more than one is competition
- Number of players in related service. For example all the self-handling that continues as a result of Ground handling policy not being implemented directly eats into our market space. Ground Handling policy was factored as available market when the bidding process and investments were made.
- The advantage of competition is not limited to price control. Competition also improves the standard of service. In today's market scenario competition is inevitable. Although our initial license period was 7 years, there is provision to bring in third handler as competitor if throughput crosses installed capacity.

There are other parameters that one must consider before deciding on number of players in a competitive scenario.

Level of Investment: In our opinion, size of market and the amount of investment determines the number of players. New players can be introduced depending on the size of market. It may not be advisable to bring in overcapacity and excess investment when the market size is limited. This over-capacity and excess investment could be detrimental to the quality of service provided by each player.

Competition Dynamics in Current Market: Competition certainly exists in even two handler markets due to active competitive forces including strong bargaining power of customers, thereby ensuring best deals for them.

Service Parameter: Price is determined by scope of service and level of service. Integrating these services directly reduces the cost to the Airlines.



313



Competitive Disadvantage: A level playing field is a pre-requisite before judging competitiveness of handling operations. Although Government of India had committed for implementation of Ground Handling policy this has been repeatedly postponed. ISPs like us who came into the business with considerable investments agreeing to the terms of airport operator are truly at a disadvantageous situation. All the stringent operating norms from the airport operator apply to us ISPs when the domestic carriers under the guise of self-handling operate under a different set of operating standards.

Bargaining power of Airlines: The Airlines have strong bargaining power with the handlers. Airlines negotiate on service levels and bargain for global deals on handling rates.

Illustration:

Let us consider two handlers at same airport; Handler A and Handler B with capacity to handle 10 customers each.

Handler A has 7 customers and Handler B has 8 customers

One of the customers of Handler A opts out and decides to cancel operations to that particular station.

Handler A's investments are made and to sustain expected rate of return A would have to increase its tariff to existing 6 customers.

Notwithstanding service performance when asked to pay more, existing Customers of Handler A may seek proposal from Handler B.

Handler B could offer same or lower price to existing customers of Handler A and some customer will go to Handler B.

This demonstrates that in a two handler market itself, competition exists based on price. Today we can demonstrate that our prices are competitive and service levels are substantially ahead of any other station.

We would like to stress that just as in other airports in the world, it will not be financially viable to have three or more ISPs in every airport due to varying market and investment considerations. Forcing more parties for the sake of competition shall throw excess capacity, which will make it impossible for any handler to have positive returns. This will adversely impact ongoing investment requisite to sustain world class service standards. There could be mechanisms to monitor tariffs being charged but AERA shouldn't be controlling or determining them pegged to FROR.



314

We, therefore, propose that AERA re looks at the competition clause 5.1 of the Guideline and relates the number of ISPs to the sustainable available volumes and should not apply an arbitrary blanket philosophy across the stations. If AERA determines that a minimum number of providers have to be defined then it should be two and not three as is AERA's current point of view.

Additionally, considering the reasons mentioned above, the airport operator has already included clauses for entry of third service providers in the market after volumes cross certain levels. This is to protect economic vitality of service provider, and the calibre of services delivered by the provider. The airport operator is cautious of the fact that excess investment would lead to high cost of operations. Moreover, the concession agreements also prevent the ground handler to charge rate higher than that prevailing at neighboring airports.

So, if AERA evaluates competition in terms of market power, it is already effectively regulated under the concession agreement with the Airport operator.



315

#### 4.0 MBGH Position on Proposed AERA Technical Guidelines

##### 4.1 Aggregate Revenue Requirement

No compensation for Service: Aggregate Revenue Methodology essentially treats ISP's like us as infrastructure business and uses Regulated Asset Base to estimate profits. Using Asset base as basis for determining the profitability and hence yield ignores the fact that some of the assets could be leased and therefore RAB will be reduced to that extent although that asset could be a relevant asset for providing service. Extending this argument further, if all the assets were leased then there is no compensation for providing service. We are service providers and have labor intensive operations, our expertise lies in providing world class service. Our Standard Operating Procedures (SOP) and globally leading IT systems are the outcome of our many years of international experience. The reward for service motivates us to continue improving the SOPs.

In the Guidelines' ARR approach, we are not compensated for our expertise which is world class service. We therefore propose that an extra term should be added to the ARR formula as income for the services offered.

We propose addition of another profit element relating to service, RS such that ARR gets restated as below

$$ARR = (RAB \times FRoR) + RSt + Dt + Ot + Tt$$

Where RS is some percent of the Ot which represents the activity level.

Cost plus approach is not an ideal mechanism to bring efficiency in business. Mathematical formulas for efficiency index cannot bring efficiency in system and deliver quality to customer. The price is relative to service. If that relation is challenged, the motivation of service provider will be lost.

Efficiency mechanism build in the guideline is penalizing rather than rewarding. It completely passes on the benefit to trade and de-motivates the operator to improve.

**4.2 Fair Rate of Return (FRoR):** We welcome the approach taken by AERA to determine ARoR but disagree on use of un-modified Capital Asset Pricing Model for determining cost of equity Re for Project Specific business like ours. The approach also determines the weighted average cost of debt for arriving at FRoR.

Further, FRoR determined by AERA can itself be challenged by other industry players as they may not have the same returns, notwithstanding the fact that they operate in different business environment. Please also note that AERA's method proposes to keep Re same for

entire control period of 5 years. This is very simplistic assumption as it implies betas are not changing over time. In reality, beta change over longer period like 5 years and hence expected return on equity can not fixed for 5 years.

**4.2.1 Cost of Equity:** AERA proposes to use Capital Asset Pricing Model for determining cost of equity for MBGH. AERA also specifies following formula

$$R_e = R_f + \beta (R_m - R_f)$$

We are Special Purpose Vehicle entity especially created to manage the Ground Handling services at Hyderabad airport. This SPV manages a Public Private Partnerships type of business for limited concession period. Using CAPM in our case is not a good measure as we are not like normal business that has no defined end.

**4.2.2 Risk free rate:**  $R_f$  seems to be assumed same for control period although it is nominal risk free rate implying it has inbuilt inflation element. For Example the real Risk free rate will be fixed but nominal risk free rate will change per the Fischer's formula stated below

*Illustration:*

In year 1;

If, Inflation  $i = 5\%$ , Real Risk free rate  $R_{rf} = 5\%$ , then the nominal risk free rate  $R_f$  is calculated by Fischer Formula

$$(1 + R_f) = (1 + i) \times (1 + R_{rf})$$

$$R_f = 1.05 \times 1.05 - 1 = 10.25\%$$

In year 2;

If, Inflation  $i = 10\%$ , Real Risk free rate  $R_{rf} = 5\%$ , then the nominal risk free rate  $R_f$  is calculated by Fischer Formula

$$(1 + R_f) = (1 + i) \times (1 + R_{rf})$$

$$R_f = 1.1 \times 1.05 - 1 = 15\%$$

Per the illustration above, in year 1 shareholder are expecting lesser returns compared to the returns in year 2 because in year 2 shareholders are expecting compensation for higher in-country inflation. We therefore propose that AERA should look at using different  $R_f$  in each year of control period.





317

**4.2.3 Market Risk Premium:** We welcome AERA's proposition to allow us to add country risk premium to the estimate of market risk premium. We take this opportunity to modify the risk premium formulae by adding a country risk premium to market risk premium to make it applicable to Indian context. We also believe, per standard worldwide accepted norm, we would accept use of arithmetic average as allowed by AERA to arrive at market risk premium.

**4.2.4 Equity Beta:** AERA allows ISP's to use an international comparator for estimating asset beta. Guidelines Sec AI.4.2.3(1)(iii), a detailed justification for use of such comparator is required which we believe is not possible. There are two reasons for it;

- In India we do not have any ISP's that are publicly listed in stock market.
- If we select international comparator, AERA requires that the comparator should be facing same or similar regulatory environment. As stated earlier in this document, tariff regulation does not exist anywhere in the world for ground handling services.

However, as per the risk listed out below our risk profile, to a large extent, falls in line with airports' risk that we operate with.

S. No.	Risk Category	Risks	Impact of risk
1.	<b>Project Risk</b>	Uncertainty in development costs, schedules, penalties, design implementation.	Increased Project costs or cost of penalties
2.	<b>Operating Risk</b>	Demand risks, volume is not controllable, Price escalation may not match cost escalation, dependence on Security at the terminal	Cash flows and profitability affected. Needs strong management, partly controllable
3.	<b>Sovereign-macroeconomic</b>	Economic situation in India, ups and downs in the global economy controls the aircraft movements High inflation and inability to pass it on.	Loss of revenue
4.	<b>Sovereign-Political and Legal</b>	Change of laws, enforceability of contracts and change of political scenario.	Concession period subject to changes results in returns likely to be affected.

318

**Beta, R<sup>2</sup>, Volatility and Returns of SENSEX Scrips for One Year Period  
(August 2009 - July 2010)**

Scrip code	Company	Beta Values	Co-efficient of Determination (R <sup>2</sup> )	Avg. Daily Volatility (%)	Returns (1 year) (%)	Weightage (%) in SENSEX as on 30/07/10	Free-float Adj. Factor as on 30/07/10
532868	DLF Ltd.	1.6	0.51	2.6	-23.94	0.92	0.25
500440	HINDALCO INDUSTRIES LTD	1.92	0.57	2.95	59.98	1.54	0.7
500390	RELIANCE INFRASTRUCTURE LTD	1.26	0.45	2.18	-8.08	1.16	0.6
500900	STERLITE INDUSTRIES.	1.69	0.59	2.57	8.47	1.9	0.45
532532	JAIPRAKASH ASSOCIATES LIMITED	1.72	0.56	2.66	-26.28	0.99	0.55
532286	JINDAL STEEL & POWERS LTD.	1.24	0.43	2.2	27.08	1.88	0.45
500470	TATA STEEL LIMITED.	1.7	0.59	2.56	16.09	2.39	0.7
500209	INFOSYS TECHNOLOGIES LTD.	0.75	0.36	1.45	35.13	9.76	0.85
507685	WIPRO LTD.	0.8	0.3	1.7	39.73	1.45	0.2
532540	TATA CONSULTANCY SERVICES LIMITED	0.77	0.28	1.7	59.78	3.54	0.3

**Beta = Co-variance(SENSEX, Stock)/ Variance(SENSEX)**

**R<sup>2</sup> = (Correlation)<sup>2</sup>**

**Average Daily Volatility = One standard deviation of daily returns of individual stock price for last one year**

**Returns = % variation in the stock price over last one year**

As apparent from the table above the beta for most known companies that are in infrastructure sector have beta of 1.6 to 2.0. The betas for infrastructure companies has higher co-efficient of determination compared to those for purely IT Service companies. This also suggests that expected return for infrastructure companies are better explained by market factor alone. Although ISP's are providing services we have also invested in the infrastructure and hence our business has more similarity to infrastructure companies like airport operator. We therefore believe our betas would be closest to Airport Operators Betas. As apparent from above Beta table our Beta should reflect infrastructure especially airport operator but since it is difficult to estimate service sector betas we believe some additional factor should be allowed therefore bring it between 1.8 and 2.0

**4.2.5 Alpha:** Like any investor, we also expect to be compensated for both asystematic and systematic risk. By application of CAPM for estimating return on equity, AERA proposes to compensate MBGH for systematic risk measured by market risk and therefore offers a proportion of market risk premium. However, CAPM cannot be satisfactorily applied to equity of MBGH because we face risks that are not only typical of Airline business but also that are location specific as detailed below. As a compensation for this asystematic, equity holders of MBGH propose to add another term ( $\alpha$ ) alpha similar to the portfolio managers who would deliver more than CAPM in real time.





319

Therefore we request addition of  $\alpha$  and request acceptance of CAPM in its modified form as below:

$$R_e = \alpha + R_f + \beta (R_m - R_f) + \text{Country Risk Premium}$$

We recognize that, theoretically CAPM relationship of linking cost of equity to market portfolio eliminates scope for alpha but studies<sup>3</sup> have shown that CAPM predicted expected returns are always incorrect and actual realized returns are always more or less. CAPM is outdated model and now many multifactor models like Fama French<sup>4</sup>, Arbitrage Pricing Theory<sup>5</sup> are used to estimate expected return.

Risks Specific to ground handling industry and MBGH

S. No.	Risk Category	Risks in Handling business	Impact of risk
1.	<b>Political instability</b>	Division of State between AP & Telangana – negative influence on domestic and international business sentiments	Division of business volumes and reduced pace of growth
2.	<b>High fixed costs</b>	With any down-trend, while business volumes decrease significantly, majority of costs such as customs, security, rent, depreciation, maintenance, manpower costs, etc. remain same.	Speedy reverse cash flow
3.	<b>Regulatory Uncertainty</b>	Implementation or non-implementation of Ground Handling Policy	Impact on handling volumes is direct. No say in decision making
4.	<b>Dependence and Limited Influence</b>	Ground handler has very limited influence on increasing the business volumes. The business decision of airline is based on passenger traffic, yield and route profitability.	Irrespective of ground handling option with great investment in modern equipment and service, passenger load, yield and route profitability decides volumes for handling.
5.	<b>Global risk</b>	Airport traffic is exposed to risks on a global scale. The traffic of aircrafts is influenced by global factors.	Significant

<sup>3</sup> Merton H Miller and Myron Scholes, "Rates of Return in Relations to Risk: A Re-examination of Recent Findings", in Studies in the Theory of Capital Markets, Michael C.Jensen, ed. (New York: Praeger, 1972); Schmucl Kandel and Robert F.Stambaugh,"Portfolio Inefficiency and Cross-Section of Expected Returns", Journal of Finance 50 (1995)

<sup>4</sup> John H Cochrane, "New Facts in Finance" Economic Perspectives XXIII (3) Third Quarter 1999( Federal Reserve Bank of Chicago)

<sup>5</sup> Pg 294-349, Zvi Bodie, Alex Kane and Alan Marcus, " Investments" Seventh Edition, McGraw-Hill International Edition



320



There are many uncontrollable factors including acts of terrorism, natural disasters, security challenges, economic conditions, etc.

This should add  $\alpha$  of at least 5-7%

Below is our estimate of return on equity;

$R_f = 7-8\%$

$R_m = 14 - 16\%$

$\beta = 2.0$

$\alpha = 5-7\%$

Country risk premium of 5-7%

Hence our  $R_e = 7\%+5\%+2(15\%-7.5\%)+7\% = 39\%-42\%$

**4.2.6 Cost of debt:** AERA Proposes to review the reasonableness of sources, procedures and methods of raising finance before considering it for cost of debt. We believe these are financing decisions taken in history with constraints and situation prevailing at the time. We may or may not be in a position to undo the whole historical financing transactions. We also believe that this is outside the purview of AERA Act.

We have certain financing arrangements in place which are legal binding on MBGH. The cost of debt determination process must take these legal binding agreements and liabilities into account. Guideline Section 8.1.4, Cost of debt definition does not refer to certain debt-like financial instruments, specifically Preference Shares. The cost of these financial instruments which are based on pre-existing legal binding financing arrangements should be considered as direct cost and form part of the operating expenditure rather than as cost of debt. The concession agreement only guarantees ease of raising finance, it does not ensure best financing deals<sup>6</sup> we still have to look for best financing deals.

Per 8.1.7(a) of the guideline, gearing is calculated as weighted average WG but it appears that it is not actual weighted average but simple addition of debt divided by simple addition of debt plus equity.

**4.3 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;



321

- 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.

*Economic Definition of Depreciation<sup>6</sup>: depreciation is the amount of a firm operating cash flows that must be reinvested in the firm to sustain its real productive capacity.*

*Accounting Definition of Depreciation: depreciation is the amount of the original acquisition cost of an asset that is allocated to each accounting period over an arbitrarily specified life of the asset.*

On one hand AERA allows usage of Stock Market to determine cost of equity and on the other hand applies book value concept of depreciated asset. Capital Asset Pricing Model is an economic measure and correspondingly *economic* definition of Depreciation is more appropriate in this case.

AERA, in deducting depreciation for arriving RAB, makes implicit assumption that the depreciation cash is distributed back to shareholders periodically. Per Companies Act 1956 Section 205, the cash distribution to shareholders in the form of dividends is limited to available distributable profits after tax. Depreciation cash retained in the business is never distributed to shareholders under normal continuous business operation. The equity holders only have residual claim on the company assets. This internally generated cash always gets re-invested<sup>7</sup> into the business which is expected to deliver given FRoR. AERA recognizes that re-investments in the form of subsequent capital expenditure should give profits at the rate of FRoR but omitted to recognize the opportunity cost, in this case FRoR, of depreciation cash locked in the business.

To draw a parallel, we offer our case as an example, we have 100% equity funded investment implying that all the Regulated Asset Base is financed by equity from shareholders against opportunity cost, Re, of investing in Stock Market. In Stock Market our shareholders will get Re on the initial equity value. This equity investment will not be depreciated per accounting treatment year on year. Below illustration shows impact of using depreciated RAB on the return on equity.

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<sup>6</sup> Pg 649-700, Zvi Bodie, Alex Kane and Alan Marcus, "Investments" Seventh Edition, McGraw-Hill International Edition

<sup>7</sup> Richard Brealey, Myers and Marcus, "Principles of Corporate Finance" Eight Edition, McGraw-Hill International Edition





322

Balance Sheet of 100% Equity Funded ISP									
	0	1	2	3	4	5	6	7	8
<b>Shareholders Fund &amp; Liability</b>									
Equity (E)	1000	1000	1000	1000	1000	1000	1000	1000	1000
Reserves ( R )	0	225	425	600	750	875	975	1050	1100
	1000	1225	1425	1600	1750	1875	1975	2050	2100
<b>Fixed Assets (FA)</b>	1000	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
<b>Current Assets</b>									
Cash from Depreciation		100	200	300	400	500	600	700	800
Cash from Profits		225	425	600	750	875	975	1050	1100
<b>Total Assets</b>	0	1225	1425	1600	1750	1875	1975	2050	2100
<b>Ratios</b>									
FRoR(=Re in case Rd is zero)	25%	25%	25%	25%	25%	25%	25%	25%	25%
Profit = FRoR X RAB		225	200	175	150	125	100	75	50
Re = Profits/E (=FRoR as debt is zero)		23%	20%	18%	15%	13%	10%	8%	5%
ROACE = Profits/Capital Employed		18%	14%	11%	9%	7%	5%	4%	2%

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;

323

Balance Sheet of 50% Debt and 50% Equity Funded ISP									
Shareholders Fund & Liability	0	1	2	3	4	5	6	7	8
Equity (E)	500	500	500	500	500	500	500	500	500
Debt (D)	500	500	400	300	200	100	0	0	0
Reserves ( R )	0	124	323	497	646	770	970	1044	1094
	<u>1000</u>	<u>1124</u>	<u>1223</u>	<u>1297</u>	<u>1346</u>	<u>1370</u>	<u>1470</u>	<u>1544</u>	<u>1594</u>
Fixed Assets (FA)	1000	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
<b>Current Assets</b>									
Cash from Depreciation		0	0	0	0	0	100	200	300
Cash from Profits		224	423	597	746	870	970	1044	1094
Total Assets	<u>0</u>	<u>1124</u>	<u>1223</u>	<u>1297</u>	<u>1346</u>	<u>1370</u>	<u>1470</u>	<u>1544</u>	<u>1594</u>
<b>Repayment</b>		100	100	100	100	100	0	0	0
<b>Ratios</b>									
Re	36.0%	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%	12.5%
D/(D+E)		50%	44%	38%	29%	17%	0%	0%	0%
W <sub>G</sub>		47%							
F <sub>RoR</sub>		25%	25%	25%	25%	25%	25%	25%	25%
Profit = F <sub>RoR</sub> X RAB		224	199	174	149	124	99	75	50
F <sub>RoR</sub> = Profits/RAB		25%	25%	25%	25%	25%	25%	25%	25%
Profits/Investment		22%	20%	17%	15%	12%	10%	7%	5%
ROACE = Profits/Capital Employed		20%	16%	13%	11%	9%	7%	5%	3%

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

If the same table is worked on the undepreciated 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) RAB Changes Over Control Period: As illustrated below, profit per year reduces since it is calculated on depreciated RAB year on year. Since we are primarily service providers, but we were expected to invest in infrastructure, the incremental investment is not comparable to initial investment so our RAB will get reduced to zero or negligible in future date. Below is extreme case situation where Tariff Period 5 happens to be last year of operation and RAB is zero.



324

Aggregate Revenue Requirement						
Particulars		Tariff	Tariff	Tariff	Tariff	Tariff
INR'lacs		Year 1	Year 2	Year 3	Year 4	Year 5
Depreciated value	NBV	1,500	1,000	500	-	-
Depreciation	Dt	500	500	500	-	-
RAB for calculating ARR	RAB	1,500	1,250	750	250	-
Fair Rate of Return	FRoR	25%	25%	25%	25%	25%
Profitability	RAB*FRoR	375	313	188	63	-

In above table it is evident that throughout our concession period we will reach one year of the AERA's control period when the Profitability for us will be zero and we will lose the incentive to continue the operation at cost.

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 profitability<sup>8</sup>.

<sup>8</sup> Teresa De Lemos, Martin Betts, David Eaton and Luis Tadeu De Almeida, "The Nature of PFI", Spring 2003, Journal of Structured and Project Finance.





325

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
<b>Cash Outflow</b>						
Capital	-1500					
<b>Cash Inflow</b>						
Profit		375	375	375	375	375
Depreciation		500	500	500	0	
<b>Total Cash Flows</b>	<b>-1500</b>	<b>875</b>	<b>875</b>	<b>875</b>	<b>375</b>	<b>375</b>
IRR	43%					
Cash Flows assumptions CHANGED due to AERA method						
	Year 0	Year 1	Year 2	Year 3	Year 4	Year 5
<b>Cash Outflow</b>						
Capital	-1500					
<b>Cash Inflow</b>						
Profit		375	313	188	63	-
Depreciation		500	500	500	0	
<b>Total Cash Flows</b>	<b>-1500</b>	<b>875</b>	<b>812.5</b>	<b>687.5</b>	<b>62.5</b>	
IRR	29%					

c) RAB approach brings price differential for same service: Service providers with newer equipment will have a price disadvantage as apparent from the illustration below; ISP1 has all the new equipments and ISP2 has all the old equipments at the same airport. Based on when the equipments were bought the pricing differential is close to 36% which keep on increasing as ISPs move into concession periods. For simplicity, all other costs and taxations are assumed same and also turn are assumed to be split between two operators.



326

Two Service Providers with Same investment but Different Starting points						
ISP1 : Profitability of New Equipment Service Provider						
Particulars		Tarff Year1	Tarff Year2	Tarff Year3	Tarff Year4	Tarff Year5
INR'000						
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
Fari 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
Turns per year		20,000	20,000	20,000	20,000	20,000
Yield at ISP1 (INR/Turn)		15,000	14,000	13,000	12,000	11,000
ISP2 : Profitability of New Equipment Service Provider						
Particulars		Tarff Year1	Tarff Year2	Tarff Year3	Tarff Year4	Tarff Year5
INR'000						
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
Fari 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
Turns per year		20,000	20,000	20,000	20,000	20,000
Yield at ISP1 (INR/Turn)		11,000	10,000	9,000	8,000	7,000
ISP2 Rates Cheaper than ISP1		36%	40%	44%	50%	57%

This disparity in prices charged by ISP's is significant enough for ISP's to not invest in new equipments. 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 and keep customers. 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. This discouragement in not investing in new equipment could give rise to safety concerns to airport as well as aircrafts.



327

- 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).

#### 4.4 Forecasting RAB and Forecasting depreciation

RAB Determination Process: AERA has kept discretionary powers to exclude an asset from regulatory base. The process should be to identify usability of asset for the operation and determine criteria to exclude asset from RAB. Authority also proposes to carry on evidence based assessment of the competitive procurement process for fixed assets where original value of fixed asset is more than 5% of the investment value. We also think that this is not required as we have external as well as internal audits performed by professional audit firms.

Also AERA is looking for evidence of compliance to investment plan from competent authority. There are no such authorities that approved our investment plans, investments were based on design, functionality and service level to be offered by ISP as per concession agreement.

Accumulated depreciation for initial RAB: Authority proposes to take book accumulated depreciation for calculating initial RAB. We believe, AERA should take into account the real useful life of assets rather than book depreciation arrived at using the Companies Act. Currently, we depreciate the asset per the concession period or actual useful life whichever is lower. Here again AERA is mixing up issue of book representation with economic evaluation.

Commissioned Assets: AERA allows ISP's to take newly commissioned assets in estimating ARR but these newly commissioned assets are not always procured for providing new services, sometime these assets are merely replacement of existing assets. ISP's generally would use internal cash generated from operations to make such capital expenditures.

#### 4.5 Work in Progress

We welcome view AERA has taken on including WIP in the determination of ARR and the determination of forecast RAB as per section 8.2.7(c) of the guideline. However AERA takes cost of debt in arriving at financing allowance which is not in harmony with cost of funds. In cases, where ISP's are raising the cash for WIP from equity, AERA should allow cost of equity to determine financing allowance as it represents the opportunity cost of funds.



328

#### 4.6 Operating Expenditure

Per section 8.4(a), the operating expenditure assessment allows baseline operating costs, efficiency improvement costs and security and statutory related operating cost, we welcome this approach. However, AERA has kept discretionary powers of assessment and not defined any methodology. Also there is clarification that the interest cost for working capital loan is covered under this head but does not refer to interest cost of long term debt.

#### 4.7 Taxation

AERA disallows any penalties in arriving at the taxation amount that forms part of ARR. We think instead of going through the whole process of recalculating the taxation amount for ISP, AERA should take the actual taxes paid by ISP for estimated ARR. The taxes paid by ISPs are in line with Income Tax Act of India and we see no reason to recalculate the whole tax.

#### 4.8 Process for determining Tariff over control period: Error Correction terms and EMAY, AMAY, AY.

Process for determining Tariff for year 1 of control period: As per Section 9.6 (page31) of the guideline the method described is very cumbersome and suffers from following issues;

- We are expected to estimate WPI for the control period of 5 years; this is an impossible task as no estimation of inflation of WPI will be correct. Hence, we will inevitably introduce errors in arriving at Y1.
- We also believe that determining Xt at the beginning of the control period is also a monumental task and any assumption will be incorrect, thereby introducing errors in estimation of Y1.
- The timing of actual RAB as we move into the control period could change again introducing error in estimation of Y1.

WPI: Wholesale Price Index which AERA fixes is not correct. Although we handle variety of aircraft we still run our business like any other business with labor and other costs subjected to inflation. We think it should be consumer price index or at least left to market conditions instead of WPI.

EMAY: We think AERA has only taken one sided view by limiting the maximum on the Yield and then allowing ISP's to give discounts to retain volumes. AERA should also protect the interest of ISP's by allowing the minimum Yield that ISP's can charge. The method of calculating AMAY and AY and then calculating under over recovery is very cumbersome. We propose that AERA could simply put a band or range of Minimum Yield and Maximum Yield.



329



Also, the Error correction term for current year  $t$  takes the under/over recovery realized in  $t-2$  year to be adjusted rather than  $t-1$  year. The under recovery in  $t-2$  is loss and ISP will have to wait for two years to recover that loss. AERA should allow compensation to ISP for timing difference in loss recovery since at the start of the control period RAB xFRoR is fixed for five years which does not get fully recovered by this methodology.

The process of recovery assumes that Airlines will accept the high price, which we have all along stated is not realistic. The Yield recovery mechanism makes an underlying assumption that the price elasticity of demand is zero and that volumes will not change with Yield. But we must recognize that Airlines could move to competition at the same airport. It is in this sense we believe that the costs recovery mechanism does not work as it ignores price elasticity of demand. Since AERA has set only the higher limit ISP will have hard time pushing higher price because of under- recovery two years ago. ISP will be forced to offer discounts and carry on making under recovery.





**5.0 Possible Impact on Trade**

While the objective of regulation is to prevent misuse of monopolistic situation by ISPs, it is also equally important that benefit of regulation is passed on to trade and any incidental action as a result of the proposed regulatory regime, is not detrimental to trade. It would be important to review the following issues that may arise from the proposed regulation:

- Trade loses the negotiating power in tariff fixation. Airline loses the right to negotiate a one-to-one agreement based on the mutually agreed terms of service.
- Annual variance in tariff, upward or downward, with no direct relation to inflation, may not be acceptable. Our tariff could change because of our expectation of future volumes, costs, investment level, etc. If our investment decision and our estimate of volume has a forecast error, or if there is overall economic recession, then trade would face severe impact in terms of rates. Indirectly, AERA is passing our business risk onto trade, which will be opposed and not politically acceptable, leaving us in a potentially severe increased risk of loss.
- Since yields are capped and not directly linked to services provided, ISP will not have any incentive to provide any extra or add-on service that improves the overall logistics chain. There is no incentive for the ISP to offer other add-on services or to invest in emerging global standards or meet market flexibility. A terminal operator would limit the package of service to the commonly prevailing services at all other major airports. As the maximum allowed yield has no relation to service and since there is no benefit of increase in volumes as a result of additional services, ISPs may not undertake additional services and the caliber of service to the community will likely erode.
- As the yields are linked to investment, ISPs with higher investment will have higher tariff. If past experience is any indication, trade will not accept any increases in tariff. This may prevent any new player to enter the market.
- Under AERA methodology, any improvement in efficiency is passed on to the trade and ISP does not get to reap the benefits of its efforts. This method disincentivises the ISP to improve the service levels and efficiency and at the most can only assure average efficiency.
- All airlines have generally 2- 3 years contracts with ISPs, which will not serve its purpose from a fixed tariff point of view under AERA's tariff control regime and this, would not support Airline planning process.
- Since the volume discounts are not allowed to be clawed back, ISPs will have no incentive to extend any volume discounts to Airlines, which appears to be an unintended anti-competitive outcome. This takes away the bargaining power of customer.



330



331



Industry has recently gained from liberalization in terms of improved service delivery and world class handling operations. Regulating at such a nascent stage of handling industry will prevent further investments and benchmarks for international service standards.

In the spirit of free market economy with objective to prevent misuse of power, we propose the following:

1. AERA may instruct an airport operator to bring another provider to the airport immediately after market reaches certain level of volumes that can absorb investment without increases in rates.
2. Terms of one-to-one airline agreement should be left for the ISP and Airline to be mutually agreed upon as is the global standard.
3. Common published tariff should pass through consultative process, with AERA as party to it and any increase in tariff could be with prior approval of AERA.
4. The investment decision should be purely at investor's risk. It should not lead to change in tariff unless carried in agreement with trade.
5. Investment made to provide special facility to certain segment of customers should be at mutually agreed commercial terms.

This would maintain the efficiency and lead to continuous improvement in service levels. The benefit of increased volumes and risks of investment would remain with ISP. It will be a self-regulating mechanism with limited intervention of regulator and as a result, new entrants would not hesitate to enter the industry.



332



## 6.0 Discrepancies in Consultation Paper no.5

- During consultation meeting held on 18<sup>th</sup> August'10, it was clarified that the claw back of discounts given to trade is not allowed per the regime. However AERA consultation Paper uses error correction term to claw back reduction in yield per page 49 of Guideline.
- FRoR assumes that debt servicing is made out of FRoR x RAB, which is calculated on net Book Value termed RAB and it keeps on reducing. Rd is calculated such that it is weighted average of the loan outstanding over the loan schedule.
- Also, interest cost on the long term debt does not seem to be taken out from the operating expenditure which implies that profitability also includes interest cost payable. At this rate, the only way debt will be repaid is through the depreciation cash. Since a lot depends on forecasting of costs, RAB, WPI, WIP etc. for a long horizon of 5 years, there are going to be instances when ISPs will not have cash to operate or make reinvestments.



333



## 7.0 Our Recommendation

We thank AERA for the open process.

We believe that competition is the best way to secure the fairest deals for all stakeholders involved at an airport. Moreover, our existing value proposition to our customers has already been and continues to be shaped by substantial competitive processes that do not appear to be considered by the envisioned control methods. Competition began at the outset with the Airport Operators' robust tender program with many of our international competitors participating. As part of those tender processes, the Airports introduced the requirement that upon reaching certain thresholds, additional service providers would be brought to the airports.

Handling services around the world in general are offered in openly competitive ways. In the few instances where there is regulation, the terms of such regulation are clear at the time of service providers making the investment, so that it could be considered in the economic profile associated with the investment. We believe that the prospect of new regulation at this later juncture, particularly if it is a heavy regulatory regime will likely harm businesses like ours that have taken the risk and already made substantial commitments to improving the Indian aviation infrastructure. As such, any heavy regulation may damage the reputation of India as an attractive market and the prospect of securing additional competition into the country. In this way, regulation may actually be inimical to increased competition into the future.

We also believe that there is substantial price competition amongst airports already. Given our world class handling quality, close detail for safety & security issues and the extra services we deliver per international norms that are woven into the fabric of our operating processes, our tariff to Airlines are no higher than those provided by competing, mostly larger airports.

Despite having detailed the current scenario and commenting on AERA's draft proposal, were AERA to proceed in its process to regulate tariff following would be our recommendation to the Authority for consideration in terms of form of regulation:

- There should not be any material deviation in business environment that existed at the time of investment. If regulation were to be put into place it should apply for future business ventures/investments and not to past investments.
- Materiality limit should be increased to 10% keeping in mind the nascent stage of the industry.
- Once a reasonable limit for materiality is fixed, competition should be promoted rather than regulating market forces.



334

- With the greatest respect, we ask that AERA's earlier announcement that two service providers would represent a competitive landscape be respected, rather than three providers as more recently presented. Two players should be considered as competition as competitive environment clearly exists even in this situation.
- Tariff regulation should not be linked to profitability of ISPs.
- RAB should not be a depreciated value; it must be relevant undepreciated Capital Costs.
- Use of capital asset pricing model is not correct for our business. We recommend modified CAPM with alpha included.
- Service level differences should also be factored in tariff evaluation criterion.
- Returns for service provided should be in addition to return on investment.
- Mechanism should be derived to maintain the incentive to increase volume, to improve service level and make prudent investment decisions.
- Non-regulated services should not be brought under the net of regulation.
- Cross subsidization of revenue generated from a limited group of customers over total business volumes should not be allowed.
- Price cap approach is extremely complex and should be got away with. From our understanding, it has been a failure in Australia and New Zealand. Ministry of Transport in UK has scrapped Price Cap mechanism and has limited its scope to 'Service level definition'.
- We believe that the form of regulation needs to be largely 'Light Touch'. One way of doing it is based on benchmarking approach wherein the tariffs of all service providers for a particular service is benchmarked and that takes into consideration scope of service and service efficiency levels being offered.

To sum up, our sector is niche, self-regulated, competitive enough with inherent checks & balances and therefore, does not qualify for a complex regulatory process.





335

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