

# Hyderabad Menzies AirCargo Pvt.Ltd.



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

Shri Sandeep Prakash

Secretary

Airport Economic Regulatory Authority of India (AERA)

AERA Building, Administrative Complex

Safdarjung Airport, New Delhi

15/9/10  
1577-11

SM (ABS)

PWC

15/9/10

**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 Bhave, Chairman, AERA



**Hyderabad Menzies Air Cargo 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**

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## 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. Hyderabad Menzies Air Cargo hereafter also referred as 'HMACPL' is a cargo 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 HMACPL 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. HMACPL 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.

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 customers and trade at large 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 cargo handling sector. Our present tariff is comparable to past service providers and also with current AAI tariff while the level of investment and service efficiency is of a higher level.

We also believe that there is substantial price competition amongst airports already. Given our world class warehousing quality, and the extra services we deliver per international norms that are woven into the fabric of our operating processes, our tariff to trade are no higher than those provided by competing, mostly larger airports. The AERA process does not reflect the reality that freight can easily transit from several competing airports. Nor does it reflect the substantial difference in quality amongst us.



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Hyderabad Menzies Air Cargo Pvt. Ltd.



Materiality criteria proposed should consider and compare total market volumes (international, domestic and self handled) at different airports and raise materiality criteria 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. 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 cargo thresholds, as economic use of the warehouses is achieved, additional service providers would be brought to the airport. Till that time rates have to be competitive as against neighboring airports.

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.



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## 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. HMA CPL 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', HMA CPL is covered under this consultation paper and that it directly affects our business and tariffs.
- AERA, proposes to regulate the tariff that ISP's charge to the trade viz, Cargo Agents and 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 dwell time, information requirement etc and are not measurable. 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.



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### 3.0 HMA CPL Response to Proposed AERA philosophy

HMA CPL was asked for its input by our airport operator in the month of March 2010 regarding AERA's role in cargo and 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 cargo 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 multiple cargo operators. If increased, for the sake of having more providers, it will lead to large scale duplication of infrastructure beyond minimum economic levels. We believe that this has been objectively captured in concession agreement where threshold to introduce a second handler is clearly defined.
- 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 are necessary. 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 service quality, operating expenses and capex 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.

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 HMA CPL would like to submit to Authority our point of view on the proposal draft.



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### 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. 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.

HMACPL 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. 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 cargo handling services. Introducing tariff regulation now is in conflict with the above concession agreement, which had influenced our decision making.

We have already built modern infrastructure facility of international standards for the benefit of the trade as a cargo service provider, which is much superior in nature compared to that offered by earlier service providers. The tariff control regulation approach by 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.

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 regulation if implemented will bring in lot of uncertainty to the existing functioning of cargo 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



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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** Our business model depends on the volume of cargo flowing into our terminal which is directly linked to the tariffs being charged by the respective airlines and not on the pricing being charged by us to an airline/agent. Cargo volumes are determined by pricing from airline and cargo handlers have no control on the volumes flowing into the terminal.

**3.1.4** 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 and not on cargo volumes. If the airlines could not break even their costs on account of poor passenger factor they discontinue their operations even though the cargo volumes are good. 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 even though cargo volumes were reasonable.

**3.1.5** 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. This is also true in case of a market like HYD, which has one cargo handler. Under the B2B model, tariffs are agreed after hard negotiations, which include 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.

**3.1.6** At the time of investment HMAACPL did not factor in Tariff control regulation after four 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 are clarified at the time of award of concession or before investments are made, thereby giving fair assessment of economic environment to potential investors.

**3.1.7** HMAACPL operates Design-Build-Own-Operate-Transfer (DBOOT) model under the Public Private Partnership concept that is widely used worldwide but catching up in India. Our concession agreement offers us opportunity to DBOOT cargo terminal Hyderabad, it does not guarantee volumes at the cargo terminal. HMAACPL also 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 the 2008-09 recessions we suffered revenue

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<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



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reduction of 21% compared to forecast. 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>.

**3.1.8** 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 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

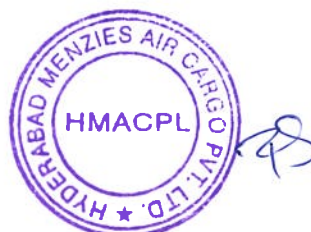
<sup>2</sup> <http://www.people.hbs.edu/besty/projfinportal/>



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		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 ground handling companies continue loosing 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



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		single handler doing both cargo and ground handling.
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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.

**3.1.9** HMAcPL current tariff, in general, is similar 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.

To further represent our fact, please find below a comparative statement showing the current tariff structure charged to agents for handling international cargo at different metro airports including those being run by AAI.

**CARGO HANDLING TARIFF COMPARISON OF INDIAN AIRPORTS**

	Hyderabad			Bangalore			Airport Authority of India - Chennai etc.			Mumbai			Delhi		
Average Cargo Volumes (in tonnes per month)															
Tariff comparison															
	GEN	SPL	PER	GEN	AVI	SPL	GEN	SPL	PER	GEN	SPL	PER	GEN	SPL	PER
<b>Terminal Charges</b>															
- Export	1	1.4	2.43	1	1.5	2.6	0.7	1.4	2.43	0.7	1.4	2.43	0.7	1.4	2.43
- Import	4.75	8.89	9.5	4.9	9.8	9.8	4.72	9.42	9.42	4.45	8.89	8.89	4.45	8.89	8.89
<b>Demurrage charges</b>															
0-72 hours	Free period			Free period			Free period			Free period			Free period		
72-120 hours	1.30	2.60	5.20	1.50	2.80	5.60	1.37	2.73	5.46	1.30	2.60	5.20	1.30	2.60	5.20
120 - 720 hours	2.60	5.20	10.40	2.80	5.60	11.25	2.73	5.46	10.92	2.60	5.20	10.40	2.60	5.20	10.40
Beyond 720 hours	3.90	7.80	15.60	4.20	8.40	16.85	4.10	8.19	16.38	3.90	7.80	15.60	3.90	7.80	15.60
Minimum charge	295	580	1160	320	625	1275	310	610	1220	295	580	1160	295	580	1160

Please note these tariffs published are for Terminal Storage Processing. We also have handling rates charged from different airlines, which are not published and are bilaterally agreed with individual airlines based on the scope of services and expected cargo volumes. This is standard practice across the industry worldwide. The fact that same airlines negotiate agreements pan-India with different handlers and have no objections with rates concluded, suggests that they get desired value against the backdrop of different service parameters. These rates are agreed by way of formal contract using IATA Standard Ground Handling Agreement.

Further please note:

- TSP CHARGES for General Cargo Rs.1 per kg at HYD includes packing charges, which isn't the case at other airports.
- Screening charges include certification at HYD. This isn't the case at other airports.



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- Our build-up and break-down rate to Airlines in their contracts is a flat per kg rate irrespective of the type of ULD. There is no fixed rate per ULD or loading in BULK as is in the case of AAI.

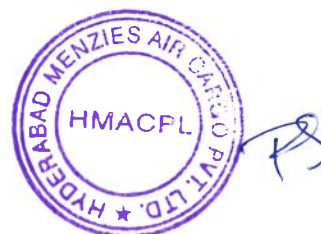
**3.1.10** The ISPs have brought in the efficiencies in the Aeronautical service economics, which has been largely acknowledged by one and all from the industry. HMA CPL believes there is strong co-relation between the calibre of service provided and price charged for the same. Whereas AERA is confident 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. Also there are other services which ISP's offer to airlines as well as agents some of which are unique to HMA CPL and some can not be charged as separate item. Comparative service offering at different airports is given below for reference.

**EXPORTS HANDLING**

	Type of Service	HYD / BLR	AAI and other Airports
1	Weight and Volume Checks while accepting the cargo	Yes	Yes
2	Use of Barcodes for cargo accepted for identification and system updation	Yes	No
3	Acceptance of Documents from Agents on behalf of Airline	Yes	No
4	Screening and Certification of Customs Cleared Cargo	Yes	No
5	Buildup of Cargo	Yes	Yes
6	Generation of Manifest for Flights Built as per Airline Plan and IATA standards.	Yes	No
	<b>Ranking on basic services</b>	<b>06</b>	<b>02</b>

**EXPORTS MESSAGING**

	Type of Service	HYD / BLR	AAI and other Airports
1	Message Exchange with Customs for Shipping Bills filed before cargo is brought to the Terminal	Yes	Yes
2	Message Exchange with Customs for Cargo received at the Terminal	Yes	No
3	Message Exchange with Airlines for Cargo received at the Terminal	Yes	No
4	Message Exchange with Customs for Let Export Order	Yes	Yes
5	FFM messages to the Destination and other places as per Airline Requirement.	Yes	No



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	All IATA messaging – Airline and Cargo Terminal Operator		
6	Web based track & trace	Yes	Yes
	<b>Ranking on Basic Services</b>	<b>06</b>	<b>03</b>

**IMPORTS HANDLING**

	Type of Service	HYD / BLR	AAI and other Airports
1	Acceptance of Documents from GHA	Yes	No
2	Segregation of Documents for handing over to Airline	Yes	No
3	Breakdown of ULD/Freight as per IGM	Yes	Yes
4	Use of Barcodes for segregated cargo.	Yes	No
5	Use of Barcodes for Storage Locations for system upgrading	Yes	No
6	Discrepancy Report through message exchange and mails	YES	No
7	Generation of Segregation report	Yes	Yes
	<b>Ranking on Basic Services</b>	<b>07</b>	<b>02</b>

**IMPORTS MESSAGING**

	Type of Service	HYD / BLR	AAI and other Airports
1	FFM Exchange with Airline	Yes	No
2	IGM messages with Customs prior to arrival of Flight	Yes	Yes
3	Message exchange with Customs for Cargo Segregated	Yes	Yes
4	Message exchange with Airlines for Cargo Segregated	Yes	No
5	Message exchange with Airlines for Discrepancies	Yes	No
6	Message Exchange with Customs for Bills of entry filed by Importer/CHA	Yes	Yes
7	Message Exchange with Customs for Out of Charge issued	Yes	Yes
8	Message Exchange with Customs for Cargo Delivered	Yes	Yes
9	Web based track & trace	Yes	Yes
	<b>Ranking on basic services</b>	<b>09</b>	<b>06</b>

**3.1.11** HMA CPL provides cargo facility and the tariff charged comprises of only 3-7% of the total shipping cost incurred by shipper. In this regard, AERA is not passing any material benefits to the shipper who is the main decision maker for consignments’ mode of shipment; viz Air-freight or Sea – Freight. Below illustration depicts share of handling cost in total transportation cost for customer.



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Destination	US		Frankfurt		Singapore		Dubai	
	Cost/ Kg.	% share	Cost/ Kg.	% share	Cost/ Kg.	% share	Cost/ Kg.	% share
Airline charges	107	92%	58	86%	46	83%	38.85	
Customs charges	1	1%	1	1%	1	2%	1	2%
Local transportation, agent's commission, etc.	5	4%	5	7%	5	9%	5	10%
Average Handling & screening charge	3.25	3%	3.25	5%	3.25	6%	3.25	7%
Total cost to customer	116.25	100%	67.25	100%	55.25	100%	48.1	100%

The regulation should also extend to the complete logistics chain for the ultimate benefit of shipper.

### 3.2 Materiality Criteria

Materiality assessment criterion is arbitrary and there is no basis to limit it to 2.5% of major airport volumes handled at the airport. Materiality cannot be measured in terms of volume alone. Cargo volumes at a particular airport depends upon various factors including local state government policies, growth of industries, size of catchments areas, nearest sea-port etc. and are not the same for any two airports. For Greenfield operations like HMA CPL 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.

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, Cargo handling facility also needs to be built for a minimum capacity 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



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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 terminal has been designed and built to an optimum capacity but at the moment it operates at a fraction of it.

The size of facility and standard of infrastructure 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 Hyderabad Cargo terminals, under JV arrangement, have jointly invested significant sums to develop the facility. The investment was made in single instance during 2006/2007 with the JV license valid for 15 years. While assessing 'Materiality' it is important to consider the level of investment vs. expected throughput levels vs. length of the concession period.

Hyderabad Cargo that runs at a volume of 1/10<sup>th</sup> of Mumbai, 1/9<sup>th</sup> of Delhi, 1/7<sup>th</sup> of Chennai and at 1/3<sup>rd</sup> of Bangalore but at the same time has to invest at least half of what Bangalore and Chennai have, to deliver a comparable service. This fact must be given its due consideration. Price-cap approach at such low volumes would not promote the operator to take risk of investment or continued application of emerging global best practices to grow the market. Moreover, it would prevent new entrant to start at low volumes as the flexibility of decision making are absent in market governed through stricter regulatory environment. The total volumes for determining materiality limit should reflect the total market volumes of the station which may include self-handled as well as domestic volumes. This will take care of the business swing from one operator/airline to other.

Air cargo services at major airports are likely to face competition from Cargo Hubs which are being developed across the country and the Cargo materiality index calculation should account for the volumes from these cargo hubs.

Further, per All.1.2, (page 68) of the Guideline, in arriving at the materiality percentage, we believe only international volumes are considered for major airports like Mumbai, Delhi and Chennai but total volumes including domestic and self-handled express cargo volumes are considered for Hyderabad. We believe that this is arbitrary and does not adequately reflect the size and scope of the marketplace as there is nothing precluding domestic carriers at major airports from contracting with a service provider. If AERA were to take both international and domestic volumes while considering total volumes for all the stations then it is likely that Hyderabad may come out of its Materiality criteria.

According to WTO's 2010 data on World Trade, India has a share of only 1.63% of international trade volumes. Out of that only 2% of the cargo travels by air. Out of that Hyderabad has a minuscule share of 3.5% of volumes handled at major airports. The developed and matured economies where volumes are several times more than volume of any airport in India, with no or very light regulation for such services, the proposed regulatory regime would secure a



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negative remark for India while making an a choice of investment decision by international players.

AERA has prescribed threshold level of 2.5% for cargo but not provided any reason/ benchmarks for the suggested limits. Thus keeping in mind the nascent stage of the industry, AERA should increase the threshold for materiality up to 10% for Cargo services.

We therefore request a higher threshold for Materiality index for ISP at Hyderabad.

### 3.3 Competition Criteria

We believe competition should be assessed based on following parameters;

- Number of players in related service providers. For example express freight service competes for cargo at HYD facility; other similar cargo facilities in the neighboring stations effectively also offer competition.
- Competition also improves standard of service. The advantage of competition is not limited to price control. In today's market scenario competition is inevitable. Although our license period is 15 years, there is provision to bring in second and subsequently third handler as competitor if throughput crosses installed capacity and viability considerations.

Other parameters must be considered before deciding on number of players in a competitive scenario.

Level of Investment vis-à-vis size of market: 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 one handler market due to competitive forces like bargaining power of customers, other cargo service providers at same or nearby airports including express cargo, sea and road freight services thereby ensuring best deals to customers.

Generic Competition: Competition can be in different forms and may not always be between service providers in the same station. We believe that we are competing against other regional cargo terminals like Chennai, Mumbai and Bangalore and with other modes of road transport due to our location placement and ease of accessibility for the shippers to these locations. HMA CPL competes with these regional stations on service delivery to shippers and airlines and has to be competitive in all levels of service offering.



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Service Parameter: Besides competition, price is also influenced by scope of service. There are many other value added services that new Greenfield airports offer at no extra cost (ref. service table under 3.1.10). Integrating these services directly reduces the cost to the airline, freight-forwarder and the shipper. Such so called 'add-on' services must also be considered in any competition analysis.

Competitive Disadvantage: A level playing field is a pre-requisite before judging competitiveness of a cargo terminal. Although Government of India had committed for non-discriminatory approach with Greenfield Airports, our business is being burdened by the Customs Authority for recovering customs staff salary, IT infrastructure and recurring cost for facility provided at cargo terminal. Non-Greenfield Airports do not suffer the same burden. We believe this to be a sovereign function of collection of customs duty, controlling cargo and passenger's movement at port of entry, and that it should be borne only if it is level playing field with other airports. Greenfield Airports in that sense are at a truly competitive disadvantage compared to other metro airports.

Bargaining power of user groups: The airline and cargo agent industry has strong lobby and they jointly bargain the tariff with handlers. The biggest evidence to that effect is HMA CPL having comparable tariff levels of AAI and no increase in Terminal Storage Processing (TSP) tariff in last two years. Airlines negotiate on service levels and bargain for global deals on handling rates. 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 two 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.

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.

Further, when considering the competitive position of a service provider at an airport where they are the sole service provider, we assert that their prices be compared vis-à-vis prices of other providers in other Indian airports.



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Additionally, considering the reasons mentioned above, the airport operator has already included clauses for entry of second or third service providers in the market after cargo 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 cargo handler to charge rate higher than that prevailing at neighboring airports.

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



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#### 4.0 HMA CPL Position on Proposed AERA Technical Guidelines

##### 4.1 Aggregate Revenue Requirement

**4.1.1 Non Cargo Revenue:** HMA CPL has been quite aggressive and flexible in meeting the service requirement of individual customers. Our bundle of service under unitization and de-unitization charge would include services more than any other terminal may be providing. For example we carry documentation service and manifestation service which is done by airlines on other airports. If the revenue of add-on service to few airlines, subsidize the tariff of other customers, giving same yield to us, we would be totally discouraged to offer any add-ons.

The non regulated revenue at the facility is subject to market forces and therefore we do not believe this requires controlling. E.g., we have rentals of offices, rates of which are guided by market forces of real estate in the surrounding area.

The formula for the aggregate revenue requirement ARR is arrived at using cost plus approach where estimated profits are added to the total costs in the business. However, the non regulated revenue is further taken out from the cost plus profit term to arrive at aggregate revenue. This implies that non regulated revenue is cross subsidizing the total costs plus approach and the ARR is net of contribution from other revenue.

We believe this cross subsidization further reduces ISP's profitability and passes the advantage to trade. This advantage can not be undone using under/over recovery mechanism detailed in Section 9 of the Guidelines. It merely adds another uncertainty to the tariff and volume relationship.

Also in ARR estimation, assets relating to Non Cargo revenue will be removed from RAB, at the discretion of AERA per Section 8.2.1(b) but contribution from Non Cargo Revenue is taken as credit thereby giving a double hit to ARR calculation.

We propose that the ARR calculation be restated to limit the revenue to Cargo handling related revenue only. The incentive to maximize revenue from other sources and to provide add-on services should be kept intact for the benefit of customers and service providers.

$$ARR = (RAB \times FRoR) + D + O + T$$

**4.1.2 Demurrage:** Most of the cargo facilities earn revenue from demurrages. HMA CPL opines that this revenue should not be treated as other Non-Cargo revenue or Cargo revenue and should be outside the purview of control from Authority. The primary reasons are:

- Demurrage revenue element is volatile and not controllable by the ISP; it can neither be reduced nor increased by ISP's.
- It is not related to cargo volumes and



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- Demurrage is determined by number of days cargo is stored in the warehouse. Free storage period is defined by Ministry of Civil Aviation.
- Demurrage can not be forecasted as these are one time events of inefficiencies due to different stakeholders other than Service Provider.

The level of demurrage goes up and down without any co-relation to volumes as evident from the regression analysis. If we run the regression of tonnage volumes to the demurrage collected we conclude that there is no statistical co-relation between the two and therefore unrelated. Demurrage is a penalty on those parties who bring inefficiencies to the cargo facility. Placing demurrage revenue in ARR calculation will simply move the Tariff up and pass on the inefficiencies to entire trade instead of limiting to those who are responsible for inefficiencies.

Below is an output of running a linear regression on 29 point data. Y is monthly demurrage revenue and X is corresponding international tonnages handled. It appear from table below that correlation between Demurrage revenue and international tonnages is only 0.063. Also since R-square value is only 1.05%, demurrage revenue can not be explained by Tonnage volumes alone.

SUMMARY OUTPUT								
Regression Analysis: Independent Variable is International Tonnage (X) and dependent variable is Demurrage (Y) in INR'0000								
Regression Statistics								
Multiple R	0.102472412							
R Square	0.010500595							
Adjusted R Square	-0.026147531							
Standard Error	303.7649024							
Observations	29							
ANOVA								
	df	SS	MS	F	Significance F			
Regression	1	26438.53161	26438.53	0.286525	0.596838			
Residual	27	2491374.13	92273.12					
Total	28	2517812.661						
	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	1438.012561	363.5142317	3.955863	0.000497	692.143	2183.882	692.1429763	2183.882147
X Variable 1	-0.063253112	0.118168256	-0.53528	0.596838	-0.305714	0.179208	-0.305714344	0.179208119
Y = 1438 - 0.06325 * X								

Main driver for demurrage is the number of days cargo stays in the terminal and the number of free days allowed to the importer. The free period is already regulated and guided by Ministry of Civil Aviation. The decision for storage beyond free period depends on importer only. The importer also has a choice to pay TSP charge and move cargo to any other bonded warehouse in the country.

Further, under the instruction of Ministry of Civil Aviation, an importer gets a free period of 72 hours to clear the cargo from customs and take delivery. If clearance is delayed for any reason, a penalty in the form of demurrage is collected from importer at the time of actual clearance.



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Depending on the number of days of delay beyond free period, demurrage is charged at pre-agreed tariff.

This proves that there is no scientific mechanism to forecast demurrage collection as there exists so much of uncertainty in demurrage revenue. The variance between forecast and actual collection can go to any extent. Moreover it is also difficult to predict what % of volumes will attract demurrage charges it may not be appropriate to fix the overall tariff of the business taking into account revenues earned through demurrages which is uncertain.

Yield should be a result of cargo handling revenue and volume. It would not be scientifically correct to include non-volume driven revenue with volume as denominator. Placing demurrage revenue in ARR calculation will simply distort the tariff calculations and would bring frequent and unacceptable variances in tariff rates.

As AERA does not regulate storage rates of any bonded warehouses of the country, ideally it need not regulate the demurrage charge for bonded warehouse within Cargo Terminal as well.

We therefore propose that demurrage collection should either be totally taken out of regulation or ISP may at most be asked to seek prior approval for any future increase in demurrage rates.

**4.1.3 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  $R_e$  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  $R_e$  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 HMAcPL. 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 cargo handling services at Hyderabad airports. 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

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

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



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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.

**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. 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 cargo 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.	Project Risk	Uncertainty in development costs, schedules, penalties, design implementation.	Increased Project costs or cost of penalties
2.	Operating Risk	Demand risks, volume is not controllable, Price escalation may not match cost escalation, dependence on Customs, Security at the terminal	Cash flows and profitability affected. Needs strong management, partly controllable
3.	Sovereign-macroeconomic	Economic situation in India, ups and downs in the global economy controls the freight and the flight movements High inflation and inability to pass it on.	Loss of revenue
4.	Sovereign-	Change of laws, enforceability of contracts and	Concession period subject to





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**Political and Legal**

change of political scenario.

changes results in returns likely to be affected.

**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)**

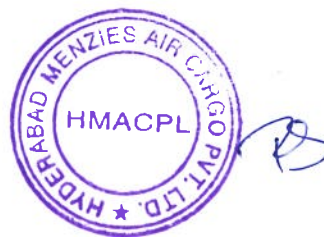
**R<sup>2</sup> = (Correlation)<sup>2</sup>**

**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 and 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 HMA CPL 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 HMA CPL because we face risks that are not only typical of Air Cargo business but also that are location specific as detailed below. As a compensation for this asystematic, equity holders





of HMA CPL propose to add another term ( $\alpha$ ) alpha similar to the portfolio managers who would deliver more than CAPM in real time.

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 air cargo industry and HMA CPL

S. No.	Risk Category	Risks in Air cargo 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>	Custodianship and security is carried as per customs and BCAS regulation Change in regulations can have significant influence on cost of running business	Impact on small private airport is faster than others. No say in decision making
4.	<b>Dependence</b>	The cargo terminal has very limited influence on increasing the business volumes. Majority of cargo flies on passenger aircrafts. The business decision of airline is based on passenger traffic. If airline decides to have more (passenger & cargo) aircraft from other nearby station, they	Irrespective of cargo facility with great infrastructure and service, passenger load decides cargo capacities

<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



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		can shift cargo through truck.	
5.	<b>Imbalance between Import &amp; Export</b>	Handler has no influence on balancing import and export volume. Hyderabad has strong export market with very limited imports. Airline calculates yield on turnaround. The mismatch in volumes does not encourage cargo aircrafts to fly out of Hyderabad	Export cargo shifts by road to nearby stations
6.	<b>Global risk</b>	Airport traffic is exposed to risks on a global scale. The traffic of aircrafts and cargo is influenced by global factors. There are many uncontrollable factors including acts of terrorism, natural disasters, security challenges, economic conditions, etc.	Significant
7.	<b>Single product dependence.</b>	Hyderabad Air Cargo business is highly depended on single product, i.e. Pharmaceuticals. The changing industry standards of foreign developed nation require strict compliance to global standards in supply chain. The Indian sector of logistics chain is not in compliance to the required standards. Any regulatory implication leading to change in business equation would have severe impact on our business.	All eggs in one basket. Limited growth potential
8.	<b>Limited influence</b>	The customer decision to route cargo through Hyderabad terminal depends on the connectivity and total transportation cost. Terminal share in cost is limited to 5% of total freight cost. With one way cargo availability, Hyderabad has limited number of aircrafts which leads to high freight rates by airlines leading to risk of shift of business.	HMACPL business is largely influenced by airline and freight forwarder decision.

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



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**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 HMA CPL. 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;

- 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.

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



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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									
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
	1000	1124	1223	1297	1346	1370	1470	1544	1594
<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		0	0	0	0	0	100	200	300
Cash from Profits		224	423	597	746	870	970	1044	1094
<b>Total Assets</b>	0	1124	1223	1297	1346	1370	1470	1544	1594
<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%							
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		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.



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Aggregate Revenue Requirement						
Particulars INR'lacs		Tariff Year 1	Tariff Year 2	Tariff Year 3	Tariff Year 4	Tariff 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.



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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
<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>
<b>IRR</b>	<b>43%</b>					
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>	
<b>IRR</b>	<b>29%</b>					

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 Year1 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).

#### 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.



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#### 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 cargo in bulk 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.

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



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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 x FRoR is fixed for five years which does not get fully recovered by this methodology.

The process of recovery assumes that trade 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. Although we are only 3-7% of the total cost to the shipper the agents 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.



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## 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 cargo volumes as a result of additional services, ISPs may not undertake additional services and the caliber of service to the community will likely erode.
- Cross-subsidization by 100% of non-regulated service revenue would limit the effort of ISP to provide other facilities.
- 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.
- Investments required to support special needs of certain segment of customer would increase the rate across the board thereby subjecting the entire trade to price increase. As an example, investment in perishable facility for pharmaceutical exporters in Hyderabad would impact the rates for entire 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 dis-incentivises 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.



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- Since the volume discounts are not allowed to be clawed back, ISPs will have no incentive to extend any volume discounts to Trade, which appears to be an unintended anti-competitive outcome. This takes away the bargaining power of customer.
- While the variation to tariffs charged to each airline is regulated by the terms of contract there is a pan-India trend that tariffs charged to forwarders are generally revised once in two years. However under AERA proposal, tariffs may be required to be adjusted each year and may not be welcomed by trade.

Industry has recently gained from liberalization in terms of improved service delivery and world class infrastructure. 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 customer 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.





## 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.





## 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 or in logistics industry. 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 cargo thresholds, as economic use of the warehouses is achieved, 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 warehousing quality, and the extra services we deliver per international norms that are woven into the fabric of our operating processes, our tariff to trade are no higher than those provided by competing, mostly larger airports. The AERA process does not reflect the reality that freight can easily transit from several competing airports. Nor does it reflect the substantial difference in quality amongst us.

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%. There should be consistency in counting market volumes to include international, domestic and self handled express cargo.
- Once a reasonable limit for materiality is fixed, competition should be promoted rather than regulating market forces.





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- We have already participated in substantial competition, which is not fully recognized. In that regard, we ask AERA to consider competition with other airports as a genuine reality.
- 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, not driven by cargo volumes, such as demurrage, interest income, rent, documentation services, manifestation, etc. 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.



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