Opportunity Cost of Capital of Refundable Security Deposit

1. Background

1.1 This report has been prepared as a deliverable required under the Terms of Reference in the Letter of Award issued by AERA dated 05-12-2018 (Letter of Award No. **AERA/20010/RFP Study/COE/2018-19**).

1.2 The Telecom Disputes Settlement & Appellate Tribunal (TDSAT) in its Order dated 15.11.2018 on various appeals in the matter of determination of aeronautical charges in respect of Mumbai Airport says that Order dated 23.04.2018 on various appeals in the matter of determination of aeronautical charges in respect of Delhi Airport also applies to MIAL. The Order has directed AERA that Refundable Security Deposit (RSD) cannot be at zero cost. Its cost needs to be ascertained and made available to MIAL through appropriate fiscal exercise at the time of next tariff redetermination. Accordingly, a reasonable/fair return to be provided on RSD for Mumbai Airport, is also to be determined. Copy of the TDSAT Order is enclosed."

1.3 This report specifically refers to MIAL, however the logic used is applicable to any airport similarly placed.

2. Brief Description of the Dispute

2.1 MIAL collected RSD from concessionaires for operating non-transfer assets within the premises of the airport.

2.2 Such RSD proceeds were invested in aero assets, and therefore, MIAL expects an appropriate return on the RSD investment.

2.3 In the specific case of MIAL, AERA agreed that the RSD investment amount belonged to the airport operator but treated it as debt at zero cost (reflecting the implicit annual cost of receiving RSD from the concessionaires).

2.4 The Telecom Disputes Settlement & Appellate Tribunal (TDSAT) in its Order dated 23.04.2018 on various appeals in the matter of determination of aeronautical charges in respect of Delhi Airport concluded that, *"RSD of Rs. 1471 crores cannot be zero cost debt. Its cost needs to be ascertained and made available to DIAL through appropriate fiscal exercise at the time of next tariff redetermination"*, **TDSAT Order dated 23.04.2018, Para 119, Item vii). Para 41(iv) of TDSAT order dated 15.11.2018 for MIAL stated "(iv) In view of facts and stand of the appellants noted in paragraphs 3 and 4 of this order, it is clarified that in respect of relevant issues not pressed in these appeals but decided in DIAL's appeal No. 10/2012, that judgment dated 23-4-2018 shall govern the parties herein."** Hence, the principle applicable to DIAL as stated above on RSD also applies to MIAL.

3. Assessment of the Opportunity Cost of RSD

3.1 The RSD amounts were raised from concessionaires for operating non-transfer assets. As per OMDA/SSA, DIAL is free to use these proceeds in whatever manner they deem appropriate. This point has been amply emphasized in the TDSAT order dated 23.04.2018 for Delhi Airport (cited below), and the implications of the Order apply equally to MIAL (as discussed in Sec 1.2/Sec 2.4):

- *There is no dispute that this investment amounting to Rs. 1471 crores belongs to DIAL',* **(TDSAT Order dated 23.04.2018 on AERA Tariff Order for DIAL, paragraph 101**).

- *It ignores the liabilities which DIAL undertook by bidding for the project in view of clear stipulations as to rights in respect of such land as part of Non-transfer Assets.*" (**TDSAT Order dated 23.04.2018, Para 103)**.

3.2 Since the (explicit) cost of the Refundable Security Deposit (RSD) collected from concessionaires is 0%, MIAL was able to procure lower cost financing of aero assets.

3.3 However, as rightful owners of the RSD amount, MIAL could have used the same in alternative investment opportunities. Therefore, MIAL is entitled to receiving full benefits arising from investing the entire RSD amount in aero assets. In short, MIAL faces an opportunity cost of directing the RSD toward investment in aero assets.

3.4 The beneficiaries of the opportunity cost incurred by MIAL are airport users. To the extent that airport users are being subsidized by the (zero-cost) RSD investment in aero assets, it would be fair to provide equivalent compensation to MIAL.

4. Compensation to MIAL for Bearing the Opportunity Cost of Deploying RSD

4.1 **Option 1:** If MIAL had raised the same amount equivalent to the RSD amount to invest in aero assets, the cost of financing would have been equal to the cost of debt (at the time the RSD was invested in aero assets). Thus, **the opportunity cost of RSD would be equal to the cost of debt at the time when RSD was invested in aero assets.**

4.2 **Option 2**: The RSD amount could have been placed in an escrow account (in funds having required ratings from CRISIL, as specified in OMDA/SSA). The potential earnings on the escrow account would then be the opportunity loss to MIAL for which they must be compensated. **Thus, the opportunity cost of RSD should reflect the return on an Escrow Account.** This suggestion has been considered in **TDSAT Order dated 23.04.2018, Para 106**: '*On a careful consideration of all the relevant factors and keeping in mind the provisions in the OMDA agreement including ESCROW Agreement which authorizes investments of such money of JVC (ESCROW Account) to be invested in some specified funds having required rating by CRISIL…At the least, the cost would be the rate of return made available by the approved funds having required ratings of CRISIL*'.)

4.3 Conclusion: Option 1 recognizes that airport users benefitted to the extent of the cost of debt and hence MIAL should be compensated as per the cost of debt on RSD. On the other hand, Option 2 recognizes that the RSD amount could have been invested in an escrow account and the missed opportunity for MIAL is the earnings that would have accrued to them on a suitable escrow account; thus, the compensation to MIAL should reflect the return on an appropriate escrow account. AERA can consider both options because they are based on economic logic that tries to capture the opportunity costs. Option 2 is more difficult to implement because the rate of return on specified CRISIL-rated funds varies over time and is subject to estimation issues whereas the cost of debt required in Option 1 is relatively stable and frequently estimated by AERA when determining the annual cost of capital.