- 132 -

(9)

CATHAY PACIFIC

John R Slosar
*Chief Executive*
*Tel: (852) 2747-5327*
*Fax: (852) 2141-5327*
*Email: john_slosar@cathaypacific.com*

Cathay Pacific Airways Limited
9/F., Central Tower
Cathay Pacific City, 8 Scenic Road
Hong Kong International Airport
Lantau, Hong Kong
www.cathaypacific.com

DGM (R) 21/2
AGM (ABS) - Please.
MGR (DK) - onlease.
May also consolidate with the other comments recd.
17/2/12

OSD/II

सचिव 17/2/12

224/OSD-II 17/2/12

15th February 2012 (by email)

*(Email: kapil.chaudhary@aera.gov.in)*

Captain Kapil Chaudhary
Secretary
Airports Economic Regulatory Authority of India
AERA Building
Administrative Complex
Safdarjung Airport
New Delhi 110 003
India

Dear Captain Chaudhary

**Re: Determination of Aeronautical Tariff in respect of IGI Airport, New Delhi for the 1st Regulatory Period (01.04.2009 - 31.03.2014)**

Please find attached the response of Cathay Pacific Airways Ltd. to the Consultation Paper No.32/2011-12 published by the Airports Economic Regulatory Authority (AERA) on 3rd January 2012 for the determination of aeronautical tariff in respect of IGI Airport, New Delhi for the 1st Regulatory Period (01.04.2009 - 31.03.2014).

The proposed increase in aeronautical tariffs put forward by Delhi International Airport Private Ltd (DIAL) is of great significance. Even with the regulated increase as proposed by AERA, Delhi's charges will still be the most expensive in the world. would suggest that this is not a position to which Delhi airport should aspire.

We learned from various statements made by officials of DIAL that the expansion project of IGI Airport was cheaper, and its operating costs were much lower, than comparable benchmarked airports. However, the increases proposed are contrary to this situation. The new level of charges is much higher than these comparable airports. This has caused shock to the operating airlines as it undermines the viability of operating to IGI Airport, and it would be hugely to India's detriment if such high increases were to have the effect of reducing IGI Airport's ability to compete as an international hub.

We believe the situation revolves around the following issues:

1. Adoption of a hybrid till model in the determination of aeronautical charges;

2. Transfer of about 46% of DIAL revenue to Airports Authority of India (AAI);

3. Recovering the "targeted" revenue of the 1st Regulatory Period within a short span of 2 years; and

4. The ROE rates expected are currently set too high.

Our response in the submission has provided comments in detail on these issues. We earnestly request AERA and the Government of India to seriously consider the points we raised so that healthy and sustainable development of the aviation sector in India can be maintained.

Your kind consideration of our concerns is highly appreciated.

Yours sincerely

John R Slosar
Chief Executive

Attachment: Response of Cathay Pacific Airways Limited to the Consultation Paper No. 32/2011-12

CATHAY PACIFIC

# Response to

# The Consultation Paper No. 32/2011-12 dated 3rd January, 2012

## Issued by the Airports Economic Regulatory Authority of India

## Determination of Aeronautical Tariff in respect of IGI Airport, New Delhi for the 1st Regulatory Period (1st April 2009 to 31st March 2014)

Date: **15th February, 2012**

Prepared by: **Cathay Pacific Airways Ltd.**

## 1. Pre-amble

Cathay Pacific Airways welcomes the opportunity to provide comments on the Consultation Paper No. 32/2011-12 issued by the Airports Economic Regulatory Authority of India regarding the "Determination of Aeronautical Tariff in respect of IGI Airport, New Delhi for the 1st Regulatory Period (01.04.2009-31.03.2014).

The Consultation paper suggests increasing the aeronautical tariff by a very significant level. This is of grave concern to us.

The global economic situation is very volatile at the moment with outlook looking not promising at all. Airlines are in no exception and are seriously affected, particularly for the cargo business. Even at good times, the airline business is operating at very thin margins due to intensive competitions. The fact that a few carriers are withdrawing flights to IGI Airport demonstrates that the operation is not sustainable even without the proposed increase. With the increase, it is reckoned that more carriers may likely follow.

There is often a commonly held myth that airport charges are only a few percentages of airlines costs and are unimportant. In fact, for an airline operating out of a high cost airport, landing and other charges are a much higher portion of total costs than the global average which is heavily biased by the US system in which US carriers benefit from low airport charges at federally subsidized airports. Hub carriers compete with other hubs for connecting traffic. A hub with higher airport charges makes all connecting services more costly to provide than the competitor. In addition, the landing charges account does not include all charges paid by airlines to airports. Apart from landing charges, airlines pay various other airport charges such as terminal charges, land rent, rent for space in terminals for offices, lounges, etc.. Increase in one element of the charge will inevitably lead to increases in other elements and the combined effect could be very large. The effect of such a high level of increase will only serve to weaken the competitiveness of IGI Airport and undermine the ability to make IGI Airport a hub airport in the region. This we believe would be contrary to the objective of the project in improving and expanding IGI Airport.

Airports are long term projects. They are built to cater for growth and therefore the costs are usually front-loaded in the project life cycle. For such a long term project, there is no need to fully recover the costs related to the investment in the initial stage. Allowance should be made to under-recover in the initial years of the project, and as the project matures with growth, over-recovery may kick in. The important thing is to provide enough transparency throughout the project life cycle for tracking by the regulator.

Airports are also infrastructure projects that will help drive the economic growth of a place. There will be contribution in the context of direct employment opportunities. And indirectly, there will be the multiplier effect brought about by such employments and by tourists. Both of which will contribute significantly to the economy of India. High charges will invariably stifle growth. Appropriate consideration must therefore be given by the Government of India to keep the competitive edge of IGI Airport and to attract growth in order to support sustainable development and to maintain the prosperity of the economy of India.

## 2. Comments on the Proposal in General

It is our view that the time allowed for parties who are interested in the subject to provide inputs to the Consultation Paper is inadequate. The Consultation Paper was published on 3 January 2012 allowing responses to be submitted latest by 24 January 2012. At the request of airlines, the deadline was later extended to 15 February 2012, thereby giving slightly more than six weeks for interested parties to provide a response. Given the complexity of the issue; the amount of documents that need to be perused; the need to meet with the Authority concerned to understand the issue; and the need to seek opinions from advisors on the subject, the allowed time is grossly insufficient. In other countries where similar consultation process is conducted, a period of at least three months would be given. In this respect, it would appear that the whole consultation exercise is not meaningful at all since in-depth analysis of the proposals cannot be conducted within the short time-frame. In any case, we are providing our comments to the Consultation Paper to meet the deadline in good faith and it is probable that supplements may be provided when we have the time to more thoroughly review the issues within our organisation

It is noted that the aeronautical charges, be it User Development Fee, Landing and Parking Charge, and CUTE counter charge, are vastly different for domestic carriers and international carriers. We understand these charges are the same for the same group of users. However, in accordance with the principle of non-discriminatory application of charges, these charges and in particular the Landing and Parking Charge and CUTE counter charge should be the same for both domestic and international carriers. Charges for using such services and facilities should be worked out on basis of the efforts related to their usage, not on basis of domestic or international operation, or stage length of the flights as it bears no correlation at all.

## 3. Comments on the Tariff Determination Model

AERA has been empowered by the Government of India to provide regulatory oversight on the aeronautical tariff adjustments being proposed by DIAL. This in itself does not call for a cause of concern. The issue is that there is a pre-defined framework upon which AERA could operate, and this pre-defined framework was based on agreements entered into between the Government of India and the investors of IGI Airport. When the agreements were discussed between the Government of India and the potential investors of IGI Airport, other stakeholders that would be affected by the outcome of such agreements had not been consulted. The interests of such other stakeholders were hence ignored. On this basis, and as long as the oversight efforts of AERA are conducted in accordance with the pre-defined framework, the result would not have taken the concern and interests of such other stakeholders into account. This in all fairness will not provide an equitable balance between the interests of the IGI Airport investors and the other stakeholders.

The whole charge recovery mechanism adopts a hybrid till model. This is not a model that the airlines accept. Although there are allocation guidelines, the split of aeronautical and non-aeronautical assets, revenues, costs and charges are done purely for the sake of separation of accounts. Aeronautical and non-aeronautical services in an airport are symbiotic in nature. Passengers congregate and shop at airports because they need to ride on an aircraft for travelling to other places. The provision of apron, runways and taxiways are hence an integral part of a passenger's travelling journey and therefore the commercial revenue thus generated should contribute towards charge recovery by the Airport Operator i.e. a single till model should be adopted, as otherwise the burden associated with charge recovery of the aeronautical assets would be unbearably high for the aeronautical services users since capital costs related to apron, runways and taxiways are usually very significant.

We also understand that within the framework, about forty-six percentage of the revenue collected by DIAL would be transferred to the Airport Authority of India. This revenue transfer causes a deficit on DIAL directly and it is the basis upon which such drastic increase in charges was proposed. It is our view that this practice of transferring revenue from IGI Airport to the AAI, and thus probably to be used for the operation of other airports, has to be reviewed and abolished.

By adopting a hybrid till when determining the aeronautical tariff, there is no transparency of the full financial performance of DIAL as a whole. The current model only provides the airlines with a glimpse of the picture. We believe visibility of the full business plan of DIAL for a reasonably lengthy period in the life span of the project has to be provided in order that a better understanding of DIAL's business performance could be assessed.

In determining the charges for the users of airports, we believe the overriding consideration has to be the fact that the resultant charge must not be out of context with the objective in maintaining IGI Airport as the aviation hub in the region and thus it needs to be competitive, and in keeping with sustainable affordability of the users. The model presently adopted in respect of IGI Airport on which basis such drastic increase proposals were made is certainly in direct contrast to this objective. In addition, the proposed drastic increase seems to have been based on the need to get the "required" revenue within the remaining short time in the 1st regulatory period. The consequence is that the affordability of users of such a significant increase in cost is ignored. As a means to mitigate the impact to the users, we believe that serious consideration has to be given to extend the time-line of the recovery say to seven years instead of two years.

Most airports in the world adopt a single till model. This model copes well with market reality and provides such airports with great growth opportunities that help drive the economy of the places where such airports are situated. The hybrid till model currently adopted for DEL will be an impediment to growth and it has really to be reviewed and revised to a single till.

## 4. COMMENTS ON IMPACT OF THE PROPOSED TARIFF ADJUSTMENT

The proposed increase in Aeronautical Tariff put forward by DIAL is astoundingly exorbitant. This seems to have set a record in the history of charge increase by airports. It is a very drastic increase of 629% if it were from 20 June 2011 or an even higher 874% if it were from 1 February 2012. Despite the revision proposed by AERA, reducing the increase to an upfront level of 335%, or an equated increase of 148% each year for two years from 1 April 2012, the level is still extremely exorbitant. This will inevitably cause a very huge financial impact to the airlines. Increase under the latter mode will bring the base to a much higher level (6.15 times the current base level), which is also of grave concern to the airlines.

If the revised increases by AERA were to go ahead and by our own calculation modelling on the template used in "The 2011 Review of Airport Charges" published by Leigh Fisher Management Consultants for 50 major airports in the world, it can be illustrated that IGI airport will become the most expensive airport in the world, please see Appendix 1.

DIAL seemed to have taken pride for being able to complete the IGI Airport improvement project at a project cost benchmarked lowest amongst comparable airports across the world. It was also stressed by GMR/DIAL officials that most of the benchmarked comparable airports have operating costs higher than IGI Airport. If that is the case, we fail to understand why IGI Airport will become the most expensive airport in the world, with charges much higher than those airports. If costs of IGI Airport were the lowest amongst comparable airports, the charges ought to be the lowest as well. It would seem that something is fundamentally wrong with the financial model that IGI Airport operates against, not the realities of costs/revenue.

It is apparent that charge increase at such a drastic level will only serve to further dampen demand, compel airlines to review the commercial viability of the route, or choose other airports as transit stops (particularly for freighters). Airports play a very critical role in the economy of India. If there were further reduction of services and traffic, the consequence would be a move backward in the public good role of the airport thus affecting the economic development of India, lowering regional prosperity to the benefit of competing airports and cities.

## 5. COMMENTS ON SPECIFIC POINTS ABOUT THE REGULATORY BUILDING BLOCK

5.1 Regulatory Asset Base

5.1.1 Project costs (paragraphs 79-80) – AERA have allowed Rs12,502.66 crores against DIAL's proposal of Rs12,857 crores. However, the cost of the project has increased dramatically by 42% compared with the estimate of Rs8,975 crores in Dec07, reflecting poor control of the costs. We do not agree that all cost overruns can be passed onto the asset base for direct recovery from users; otherwise the incentive to control cost will be lost.

5.1.2 Allocation of assets (paragraphs 97-116) – It is split as 89.25% and 10.75% for aeronautical and non-aeronautical assets respectively. No details can be gathered on the actual data and hence difficult to provide further comments. AERA has also acknowledged the need for an independent analysis of the allocation and the resultant aeronautical and non-aeronautical assets but choose to defer such a study due to limitation of time. We believe this is an important item that must be given the analysis that it warrants and deferring such an analysis is not appropriate.

5.1.3 Contribution to Metro Rail (paragraphs 127-134) – DIAL has included Rs350 crores. Despite AERA's opinion that this should be considered as non-aeronautical related, it was accepted by AERA in the RAB under the consideration that AERA has till now, more or less, adopted an approach where it has desisted from reopening and revising the decisions taken by the Government of India before its establishment. Such a stance is not appropriate and we believe this has to be excluded from the RAB, since rail is not aeronautically related by nature. Besides, if the contribution were considered as deposit made by DIAL to DMRC only, it should not be considered as a part of capital cost and merely in the nature of deposit which should be refundable to DIAL in future.

5.1.4 Treatment of VRS amount (paragraphs 135-143) - The reconciliation between the audited figure of Rs. 288.82 crores and the paid figure of DIAL of Rs. 199.35 crores is needed.

5.1.5 Capex (paragraphs 144-159) – DIAL has proposed Rs230 crores. AERA has allowed Rs127.78 crores. Details of what these are should be clearly explained to the airlines.

5.2 WACC (paragraphs 209 – 266)

Cost of equity – DIAL has proposed 24%. AERA has allowed 16% based on the considerations that:

i) a strong signal needs to be given to investors since it is the first case of tariff determination by the Authority;

ii) other infrastructure regulators are offering a RoE in the range of 16%; and

iii) the Authority has been informed vide MoCA's letter No. AV.24032/037/2011-AD dated 30 December 2011 that matter regarding "Regulatory Approach of AERA – fair rate of Return on Equity (RoE)" is under examination in the Ministry and that the views of the Ministry thereon would be made available in due course of time.

Given the fact that the cost of equity of DIAL has been estimated by the National Institute of Public Finance and Policy of India to be ranging from 12.7% and 14.06%, we do not see any reason to adopt a RoE higher than the range indicated.

In recognition of airports to be of strategic value in driving the economic development of a place, consideration has often been adopted by governments in using a RoE at a modest level than the one derived under pure mathematical formula. For instance, the Airport in Hong Kong adopted a RoE of 5%. The strategy adopted by the Airport in Hong Kong has been one of promoting traffic growth for the overall and greater economic return of the Airport and Hong Kong at large. This strategy has worked successfully over the years bringing healthy and sustainable growth to the place.

5.3 Depreciation (paragraphs 267-281) - We are in the strong opinion that the depreciation should be computed on actual and not on the average of the year based on half way through the tariff year.

5.4 Operating Expenses (paragraphs 282-351)

5.4.1 Operation and Maintenance Expenses - DIAL has proposed Rs3088.34 crores from 2009-2014. AERA accepted the proposal as limited time available, but may review it later. Difficult to comment as details are not available. We have no idea for instance whether the figure of 1401 manpower in 2011-12 is appropriate, given that DIAL has outsourced many of the activities it previously did by them.

5.4.2 US Dollar Exchange Rate - The calculation should be done at fixed Dollar rate and an appropriate hedging should be undertaken by DIAL against the foreign exchange and the fluctuations should not affect the tariff price adversely.

5.5 Taxation (paragraphs 352-353) - We strongly object that the corporate tax pertaining to AERA service at Airport be included in the cost for the purpose of determination of tariff. Corporate tax liability is below the line adjustment and cannot be passed on as cost to the airlines for the purposes of determination of tariff. It is the liability to be borne by DIAL and not shared by airlines as part of tariff.

5.6 Sharing of non-aeronautical revenue (paragraphs 354-382)

5.6.1 CUTE counter charge- why should there be discrimination between domestic and international operation, and to such a great extent. Rs500 per flight domestic vs Rs1,500 per flight for international.

5.6.2 Revenue from non-transfer assets – DIAL excluded it. AERA accepted DIAL's proposal. We believe it should be included as the revenue is indirectly generated due to airport operations.

5.7 Treatment of Cargo, Ground handling, and Fuel Throughput Revenues (paragraphs 383-412) - DIAL excluded these revenues. AERA accepted DIAL's proposal. We believe it should be included as the nature of the service is more related to aeronautical.

## SUMMARY

The absence of data details has precluded a more in-depth analysis to be conducted on the various levels of increases proposed. It is suggested that apart from observing the principles as enshrined in the price regulation framework, the ICAO recommendations such as transparency, non-discrimination and adequate consultations in respect of airport charges setting should also be followed. In addition due cognizance has to be taken in respect of the strategic value of IGI Airport and its contribution to the economy of India

Whilst we have provided comments on some of the technical aspects of the regulatory building blocks, we believe only through a complete review and revision by the Government of India of the terms in the pre-defined framework upon which price determination of aeronautical tariff in respect of IGI Airport is constructed would ensure a right balance is struck between the investors of IGI Airport and the users. If not, the competitiveness of IGI Airport will be severely weakened thereby adversely affecting the growth being planned for and ultimately the economic development of India at large.

On basis of the aforementioned comments, and in order that a fair account of revenue to DIAL and a fair account of charges to the users of IGI Airport could be maintained, we urge the Government of India to:

1. Adopt a single till model;
2. Review the transfer of 46% of DIAL's revenue to AAI, allowing DIAL to fully retain such revenue;
3. Review the expected RoE return which is currently set too high.
4. Extend the recovery period for the 1st regulatory period to seven years.
5. Make visible the financial performance of DIAL preferably in the form of a business plan of DIAL for a reasonably lengthy period in the life span of the project;

Cathay Pacific Airways strongly requests that the proposals be reconsidered in light of the comments made in this submission.

## Appendix 1 – Leigh Fisher – Airport Charges Index 2011