In Response to **Consultation Paper No. 04/2018-19 of Airports Economic Regulatory Authority of India in the matter of Determination of Fair Rate of Return (FRoR) to be provided on Cost of Land incurred by various Airport Operators of India dated 08th May, 2018**

Reference is made to Para 6.2 in the above consultation paper "The Authority welcomes written evidence- based feedback, comments and suggestions from Stakeholder's on the proposal made in (Para 5 above), latest by **05.06.2018** at the following address."

Accordingly set out below are our response to Para 5 (5.1, 5.2, 5.3 and 5.4) in the Consultation Paper

In 5.1 of the consultation paper the authority is of the view that

5.1 Judging the scenario analysis has stated above the Authority is of the view:

5.1.1 The cost of land in case of airports tends be high because the land is located in or in the vicinity of urban area.

5.1.2 The percentage increase in tariff in case the cost of the land is amortized over 30 years concession period will be lower.

5.1.3 It will also be fair on the investor who exits in between the concession period since the valuation of the business/ share price will be based on the then land price and valuation and income potential.

5.1.4 The Authority intends to take the value of land being utilized for aeronautical purpose only providing a return on land cost.

5.1.5 With the development of an airport, the state government also benefits in the form of increased value of land and increased economic benefit from Airport related activity.

5.1.6 In public interest, the return on cost of land should be such that its impact on tariff is minimum.

<u>RESPONSE to 5.1</u>

Reference to point 5.1.2 where the concession term has been stated as 30 years, it is recommended that the term not be fixed at 30 years, instead, while determining the term due regard may be had for factors such as :-

- Concession agreement clause stipulating that ending the Concession term be the prerogative of the Operator (not State) eg., Bangalore 30+30 years,
- where the airport asset envisaged is to cater to high traffic volume geographies rendering the asset more capital intensive than usual,
- where subsequent capacity expansions would warrant longer gestation periods than usual

Reference to point 5.1.4 the use of phrase "aeronautical purpose" should mean <u>airport purpose or airport revenues</u> i.e. aero + non-aero revenues. The Initial or Revised Master plan as applicable could be the basis but periodically the land utilisation ratio and activities engaged in by the airport must be reviewed.

In 5.2 of the consultation paper the authority is of the view that

5.2 In view of the approaches suggested to provide return on land of cost, the Authority proposes to conduct stakeholders' consultation and obtain view regarding rate of return to be provided on cost of land in the following situations:

5.2.1 Where airport operator is required to bear the cost of acquisition of land

5.2.2 Where land has been provided to the airport operator by way of equity contribution by the equity shareholders

RESPONSE to 5.2.1

Regarding the rate of return to be provided on cost of land where the airport operator is required to bear the cost of acquisition of land our observations are categorised in

(i) Ownership model
(ii) Lease model

Ownership model

Land to be considered as a separate Asset block to determine return

Land when owned by AO (Airport Operator) must not form part of RAB. Return must not be computed using FRoR methodology. Reasons stated below

- Land intrinsically is a perpetual asset lending to appreciation. Return on land, an asset that is perpetual and appreciating is not feasible
- RAB comprises depreciable assets. Land cannot be included in this RAB for calculation of return.
- In lieu of return on land the AO can be compensated for cost of land which in turn can be considered as Pass-through.

Rate of Return under various scenarios set out below

AO Acquires land from	AO funds land acquisition via	Recommended compensation	Structuring the compensation	Remarks
State or Private Agency	Grant	Nil	Nil	See Explanatory note 1 (a)
	Internal Accruals	Risk free rate – Long term Government bond rate(Guidance from Return on Equity in the WACC computed by Authority)	Compensation can be similar to a lease rental structure and considered as a pass-through	See Explanatory note 1 (b)
	Debt	Risk free rate – Long term Government bond rate(Guidance from Return on Equity in the WACC computed by Authority)	Compensation can be similar to a lease rental structure and considered as a pass-through	See Explanatory note 1(c)
	Pre-Funding	Nil	Nil	See Explanatory note 1 (d)

The above table sets out situations where AO has to acquire the land by paying a consideration, in other words, bear the cost of acquisition of land. Treatments vary based on source of funding & such sources could be Grant, Internal Accruals, Debt, Pre funding or a combination of these.

The Cost of the land so incurred should be compensated via structured payments **akin** to "lease rentals". The basis for fixing the compensation should be sensitive to the nature of funding pattern, be aligned to the WACC methodology set by the Authority and exert minimal volatility on tariff.* **Explanatory note 2**

Explanatory note 1 (a)

The AO may obtain a grant from the State/Central/Any other agency to fund/partly fund the land acquisition. Considering that the transaction nature is that of a Grant and since the relationship envisaged is that of a Grantor and Grantee no compensation for land cost is proposed in this case. The over-riding emphasis is on the strategic need for this asset and the socio-economic benefits generated to the ecosystem.

Explanatory note 1 (b)

The AO may fund land acquisition via internal accruals and hence may wish to earn a return on such funds. Funding via Internal accrual is a healthy option and must be encouraged since it enables the private party to stay committed to the long term project and alongside acts as a measure of disciplined cash flow utilisation from this project.

Thought process on establishing compensation: The rate of return for such invested internal funds could seek Guidance from the "return on equity" that is inbuilt in the WACC rate computed as per AERA methodology for tariff determination. At the same time this rate must be representative of the Risk free rate of return on long term Sovereign or Government Bonds considering that the Asset has Sovereign backing and is intensely regulated, the cash flows are risk free and long term visibility.

Thought process on designing the structure : Compensation can be structured either as equal instalment over the concession period or to start from a nominal value and progress to higher values in later years as cash flows and traffic increase and **factoring time value of money.** Requisite provisions may be built-in to revisit the compensation to ensure that there is least amount of volatility to tariff imposed on user.

Explanatory note 1 (c)

The AO may fund land acquisition via debt. In which case the AO would incur interest expenses which is reimbursed in the prevailing tariff determination methodology. The principal repayment could be covered by establishing and designing the compensation as explained in Explanatory note 1 (b) above. In case where compensation envisaged is different from the risk free rate it could be pegged between the risk free rate and WACC based on the project and/or situation. It must be noted that such debt could be secured at advantageous rates considering that it has State asset as security backing & risk-free long term cash flow visibility,

Explanatory note 1 (d)

Pre-funding in case of Greenfield AAI projects via Asset Development fee could be resorted to by the AO to fund land acquisition. It is recommended that this be opted for as the last resort since this front-loads the passenger charge and is extremely burden-some in projects such as this which are not only long gestation but typically take longer tenures to stabilise and yield steady returns. No compensation needs to be envisaged in this scenario since it is Pre-funded and involves no cost to the AO.

***Explanatory note 2**

The Land Lease Agreement (LLA) between BIAL and KSIIDC for the KIA airport is explained on Page 52 Note number 25 of Annual Report 2014-15. This note details the methodology of Lease rental structuring. As per this note, it is observed that the cash flow to acquire such asset for KSIIDC is approximately Rs 212 crore. The lease rentals scheduled to be paid by BIAL over the entire concession agreement term to KSIIDC as computed based on this note is approximately Rs 1650 crore. It is observed that at ~6% pa discounting rate the project is at positive NPV. In case of BIAL project during this time the WACC employed by the Authority in the tariff order for the First control period was at ~12% pa. It is observed therefore from the State's perspective the ~6% pa provides return to recover the cost of the land over the tenure of land lease agreement (concurrent to Concession Agreement term).

Logic is that the sum of the net present value of the cash flows must be positive i.e., total lease rentals over the project tenure must be equal or higher than the acquisition cost.

In determining the compensation, it is recommended that representative long term risk free Government bond rate of return be used. If the situation requires compensation beyond this rate then the WACC rate with relevant adjustments could guide the process since it is a composite rate with methodology that factors return for both equity and debt albeit at a specified D:E ratio. Hence the risk free government bond rate provides asset replacement value or principal repayment as the case may be.

In the above case, the difference between 12% and ~6% reflects an adjustment of the WACC Rate to include variables such as expected performance of the project, the relative strategic importance & other considerations from State and Central perspective, social and economic benefits the state expects to derive from such infrastructure project, Risk perception of the project. With specific reference to "Risk perception of the project" it is pertinent at this juncture to note that the long term cash flows from an airport project is considered least risk. This is because the cash flows enjoy the backing of a sovereign asset and since airports are regulated under an independent authority such as AERA, they are subject to intensive regulation which increases the assurance of the long term cash flows rendering it a risk-free return.

Lease model

In cases where Land is leased from State/Private agency a formal lease rental agreement would anyways be established between the parties which in effect reflects the expected return for the lessor and from the lessee perspective (AO) this would form part of Operating expense and hence Pass-through during tariff determination

Lease Model						
Lessee	Lessor	Pay out	Treatment	Period	Document	Example
Airport Operator	State or Private Agency	Lease Rental	Pass through	Entire concession term	Land Lease Agreement	Green Field airports in Bangalore, Hyderabad

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5.2 In view of the approaches suggested to provide return on land of cost, the Authority proposes to conduct stakeholders' consultation and obtain view regarding rate of return to be provided on cost of land in the following situations:

5.2.1 Where airport operator is required to bear the cost of acquisition of land

5.2.2 Where land has been provided to the airport operator by way of equity contribution by the equity shareholders

RESPONSE to 5.2.2

Where the stakeholder is allotted equity shares in lieu of land provided for the Airport project the equity shareholder could derive benefits by getting returns on such investment either in the form of dividend and/or capital gains at time of divestment. Any return for such investment over and above dividend or capital gains is not considered reasonable or equitable since by nature an investment in equity is a conscious undertaking of risk in the venture for which returns are envisaged in the form of dividends or capital gains.

It is important to note at this juncture that such land which is given for aeronautical purposes also generates revenue from concessionaires, non-aeronautical sources and non-airport activities

In Para 5.3 *"The Authority proposes that the land development cost should be added to cost of asset depending on the area of land attributable to the asset. As a result there will be some assets which will be purely land, for example, taxiway, runway, etc. Going forward, the airport operator should include the land development cost of an asset in their proposals"*

RESPONSE to 5.3- To enable the airport operator to recover investment in airport infrastructure it is important that land development cost eg., land levelling costs etc., are identified to specific infrastructure and facility components such as taxiway, runway etc., since these can then be depreciated and recovered via the tariff formula.

Para 5.4 states that "The Authority suggests that the concerned state governments should provide the land to the airport operator on a lease rental system."

Response to 5.4 – We are in consonance with the view that a Lease rental structure is the most viable representative of compensation for cost of land in transactions of this nature.

ADDITIONAL OBSERVATIONS

Rehabilitation costs

In cases where the Private airport operators wishes to acquire land in densely populated regions it may lead to incurrence of high displacement charges for the settled population in that area. Such costs must be absorbed by the private promoter and not passed to other stakeholders including passenger. Alternatively an evaluation could be done against the purchase of land and rehabilitation costs vs establishment of another airport

FINAL SUMMARY

In cases where AO acquires land by paying consideration, the Cost of the land so incurred should be compensated via structured payments **akin** to "lease rentals" spread over the entire concession term. The treatments could vary depending on the funding options i.e., Grant, Internal Accruals, Debt, Pre-funding or a combination of these. The basis for fixing the compensation while being sensitive to the type of funding must ensure minimal volatility on tariff. The compensation must be so fixed so as to provide a minimum risk free return while staying aligned to the WACC rate set by the Authority.