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Menzies Aviation (India) Pvt. Ltd.

Date: 23rd December, 2010

Cargo Terminal 1 Plot No. C-64 L Bergalurs International Airport Bangalore -550 300.

To, Mr.Sandeep Prakash, Secretary AERA

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Safdarjung Airport, New Delhi 110003

Dear Sir,

At outset I would like to thank you and Mr.Yashwant Bhave, Chairman, AERA for meeting us on 9th Dec'10. Subsequent to our meeting it was proposed by Mr. Ian Gibbons, deputy director UKTI to send our technical explanation to you in writing. Please find attached our representation detailing reasons for using return on investment as measure to control tariff rather than fair rate of return on regulated asset base.

We also appreciate AERA's willingness to hear stakeholders like us and having given us the opportunity to bring our points in this important technical matter.

We operate as Joint Venture in Hyderabad and since we discussed Hyderabad cargo terminal we have to take our joint venture partners input that has resulted in delay in writing to you.

We request you to take these technical point on board in applying price cap approach to stations which do not qualify for light touch regulation because proposed guidelines per consultation paper no.5 not only have high profitability impact on our business but also brings price inconsistencies in the market place with respect to introducing competitor in same station and neighboring stations.

In case of further requirement of discussions or explanation on this technical paper, I will be pleased to make myself available.

Thanking you

Yours Sincerely

Prashant Nimgade Vice President Finance

Administration (India) Det 14

Menzies Aviation (India) Pvt. Ltd

cc : Mr. Yashwant Bhave, Chairman, Airports Economic Regulatory Authority of India





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Return on Investment and Return on Depreciated Asset Base

Return on Investment: Return on investment measures the profits that are made out of total capital investment. A project will never be undertaken if it does not give returns that satisfy minimum criteria of returns expectation based on risk profile of the project. Once these profit levels are determined for the company, the backward calculation gives the price per unit that can be offered in the market place. This is purely investment decision and reflects the project risk. We believe that it is this price that AERA should regulate and not return on equity.

This investment can be funded either by Debt or Equity in various proportions which is purely a financing decision. Irrespective of how the investment is funded the capital investment for a given project will be same and it is this capital investment and expectation of profits based on risk that determines the price to be offered in the market place. If this capital is overspent or excessive company profits are expected then prices will be higher and the company as whole is either inefficient in market or overpricing its products. This resultant under (overspent) on capital and company profit decision are linked to risk of project and not funding of the project. Hence investment decision and financing decisions are independent of each other.

Below is example of a project which requires INR 1000 of capital and project investment earns a company profit of INR 80 (8% return on investment). Cost of debt is 12% and 80% of the capital is funded by Debt.

As we can see, the company profit as percent of investment is fixed across all 8 years but return on equity increases over same period. Also note in initial years return on equity is zeroed out since company cannot service debt at the level at which profits are realized implying that either Promoter defaults on the lender or pumps in fresh equity to service debt. In short, higher the debt higher the risk of default risk promoter faces. Also note that this default risk is solely of promoter because of choice of funding arrangement. In order to compensate for this default risk, promoter gets compensated in later years by making returns in excess of 10%-34%.

Secondly debt is not freely available as promoters are often required to offer collateral for borrowing from lenders. Promoters have to pledge certain assets which can never be reused during the tenure of loan period. There is opportunity cost of this collateral that is captured in the equity returns excess of cost of debt in funding arrangement.





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| Illustration | Balance Shee | t of Compa | ny funded i | y Debt and | Equity | The state of the s | in new and | A service |
|----------------------------------|--------------|------------|-------------|------------|--------|--|------------|-----------|
| INR | | | | | | | | |
| Shareholders Fund & Liability | 1 | 2 | 3 | 4 | 5 | G | 7 | |
| Equity (E) | 200 | 200 | 200 | 200 | 200 | 200 | 200 | 200 |
| Debt (D) | 800 | 700 | 600 | 500 | 400 | 300 | 200 | 100 |
| Reserves (R) | -116 | -120 | -112 | -92 | -60 | -16 | 40 | 108 |
| | 884 | 780 | 688 | 608 | 540 | 484 | 440 | 408 |
| | | | | | | - | - | _ |
| Fixed Assets (FA) | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 |
| Depreciation Cumm | 100 | 200 | 100 | 400 | 500 | 600 | 700 | 800 |
| Not Book Value (RAB or NBV) | 900 | 800 | 700 | 600 | 500 | 400 | 300 | 200 |
| Current Assets | | | | | | | | |
| Cash from Degreciation | 0 | 0 | O | () | 0 | a | 0 | 0 |
| Cash from Profits Ipsa Interest | -16 | -20 | -12 | 8 | 40 | 84 | 140 | 208 |
| Total Assets | 884 | 780 | 688 | 608 | 540 | 484 | 440 | 408 |
| Debt Repayment | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |
| Company Profit | 80 | NO | RO | 80 | 80 | 80 | AO. | 80 |
| Interest Portion (Rd) | 96 | 84 | 72 | 60 | 48 | 36 | 24 | 1.2 |
| Equity attributable Profits (EP) | ٥ | 0 | 8 | 20 | 32 | 44 | 56 | 68 |
| | | | Ratios | | | | | |
| Re | 0.0% | 0.0% | 4.0% | 10.0% | 16.0% | 22.0% | 28.0% | 34.0% |
| Rd | 12.0% | 12.0% | 12.0% | 12.0% | 12.0% | 12.0% | 12-0% | 12.0 |
| Company Profits/Investment | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.0% | 8.09 |

Please note below how the return on equity changes for various levels of debts in the company. Higher the debt, higher the risk of default promoter faces and hence gets compensated accordingly. The promoters cannot off-load this default risk to market or customers because each company has different debt equity structures.

| | | Return on Equity (Re) for 8% return on investment) | | | | | | | | |
|---------------------|-----|--|--------|--------|--------|--------|--------|--------|--------|--|
| | | Year 1 | Vear 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 | Year 8 | |
| | 10% | 7.6% | 8.9% | 8.9% | 8.9% | 8.9% | 8.9% | 8.9% | 8.9% | |
| | 20% | 7.0% | 8.5% | 10.0% | 10.0% | 10.0% | 10.0% | 10.0% | 10.0% | |
| | 30% | 6.3% | 8.0% | 9.7% | 11.4% | 11.4% | 11.4% | 11.4Ve | 11.4% | |
| Debt percentage | 40% | 5.3% | 7.356 | 9.3% | 11.3% | 13.3% | 13 3% | 13.3% | 13.3% | |
| for fixed 8% return | 50% | 4.0% | 6.4% | 8.8% | 11.2% | 13,6% | 16.0% | 16.0% | 16.0% | |
| Investment | 60% | 2.0% | 5.0% | 8.0% | 11.0% | 14.0% | 17.0% | 20.0% | 20.0% | |
| | 70% | 0.0% | 2.7% | 6.7% | 10.7% | 14.7% | 18.7% | 22.7% | 26.784 | |
| | 80% | 0.0% | 0.0% | 4.0% | 10.0% | 16.0% | 22.0% | 28.0% | 34.0% | |
| | 90% | 0.0% | 0.0% | 0.0% | 8.0% | 20.0% | 32.0% | 44.0% | 56.0% | |

(Reproduced from our response on 15th Sept'2010)

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.



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Economic Definition of Depreciation¹: depreciation is the amount of a firm operating cash flows that must be reinvested in the firm to sustain its real productive capacity.

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

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

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

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

| | B. | slance Shee | t of 100% E | gulty Funde | rd ISP | | | | |
|--|------|-------------|-------------|-------------|--------|------|------------|------|------|
| Shareholders Fund & Liability | C | 1 | 2 | 3 | 4 | 5 | 6 | 7 | - 2 |
| Equity (E) | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 |
| Reserves (R) | 0 | 225 | 425 | 600 | 750 | 875 | 975 | 1050 | 1100 |
| _ | 1000 | 1225 | 1425 | 1600 | 1750 | 1875 | 1975 | 2050 | 2100 |
| Fixed Assets (FA) | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 | 1000 |
| Depreciation Cumin | | 100 | 200 | 300 | 400 | 500 | 500 | 700 | 800 |
| Net Book Value (RAS or NSV) | | 900 | 800 | 700 | 600 | 500 | 400 | 300 | 200 |
| Current Assets | | | | | | | | | |
| Cash from Depractation | | 100 | 200 | 300 | 400 | 500 | 500 | 750 | 800 |
| Cash from Profits | | 225 | 425 | 500 | 750 | 875 | 975 | 1050 | 1100 |
| Total Assets | 0 | 1225 | 1425 | 1500 | 1750 | 1875 | 1975 | 2050 | 2100 |
| | | Direction S | Ratios | | | | a continue | | |
| FROR(=Re in case Rd is zero) | 25% | 25% | 25% | 25% | 25% | 25% | 25% | 25% | 25% |
| Profit = FRoR X HAB | | 775 | 200 | 175 | 150 | 125 | 100 | 75 | 50 |
| Re - Profits/E (#FRoR as debt is zero) | | 23% | 20% | 18% | 15% | 13% | 10% | 8% | 5% |
| ROACE = Profits/Capital Employed | | 18% | 14% | 1196 | 9% | 7% | 586 | 456 | 2% |

³ Pg 649-700, Zvi Bodie, Alex Kane and Alan Marcus, "Investments" Seventh Edition, McGraw-Hill International Edition

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







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In short, using depreciated RAB does not correctly yield Re on equity as apparent in the 100% equity funded table above, the return on Equity never really reaches agreed Re.

Another widely accepted concept for measuring fair rate of return is return on Capital Employed. In this measure all the undistributed cash, including surplus and working capital, is expected to earn the same return as equity. Using depreciated asset method gives ROCE which is not even closer to estimated FROR.

Same illustration can be extended to debt and equity funded ISP as illustrated below;

| 1 600 61 61 600 00 00 00 61 | 2 500 400 198 1098 1000 200 800 0 298 | 3 500 300 327 1122 1000 390 700 0 422 | 4 500 200 434 1134 1000 400 600 | 5 500 100 533 1133 1000 500 | 6 500 0 720 1270 1900 600 | 7 500 0 794 1294 1000 700 | 844 1344 1000 800 |
|---|--|--|--|--|---|---|---|
| 61 61 61 00 00 00 00 | 400 198 1098 1000 200 800 0 298 | 300 322 1122 1000 390 700 | 200 434 1134 1000 -400 600 | 100 533 1133 1000 500 | 1270 1270 1600 600 | 794 1294 1000 700 | 500 844 1344 1000 800 |
| 61 00 00 00 00 00 | 198 1098 1000 200 800 0 298 | 322 1122 1000 300 700 | 434 1134 1000 -400 600 | 533 1133 1000 500 500 | 1270 1270 1600 600 | 794 1294 1000 700 | 844 1344 1000 800 |
| 000 000 000 000 000 | 1098 1000 200 800 0 298 | 1122 1000 390 700 | 1134 1000 -400 600 | 1133 1000 500 500 | 1270 1900 600 400 | 754 1294 1000 700 | 1344 1000 800 |
| 00 00 00 00 00 61 | 1000 200 800 0 298 | 1000 300 700 | 1000 -400 600 | 1000 500 500 | 1900 600 400 | 1000 700 | 1344 1000 800 |
| 00 | 200 800 0 298 | 300 700 | 600 | 500 | 400 | 1000 700 | 1000 800 200 |
| 00 | 800 0 298 | 700 | 600 | 500 | 400 | 700 | 800 |
| 0 | 0 298 | 0 | 0 | | | 300 | 200 |
| 61 | 298 | | 1000 | 0 | 100 | | |
| 61 | 298 | | 1000 | 0 | 100 | | |
| _ | | 422 | | | 100 | 200 | 300 |
| 61 | 1000 | | 534 | 633 | 720 | 794 | 244 |
| | 1098 | 1122 | 1134 | 1133 | 1220 | 1294 | 1344 |
| 00 | 100 | 100 | 100 | 100 | 0 | 0 | 0 |
| | | Ratios | | | | | |
| 1% | 36.0% | 36.0% | 36.0% | 36.0% | 36.0% | 36.0% | 36.0% |
| 45 | 12.5% | 12.5% | 12.5% | 12.5% | 12.5% | 12.5% | 12.5% |
| 90 | 4496 | 3875 | 25% | 17% | 0% | 0% | 0% |
| 135 | | | | | | | |
| % | 25% | 25% | 25% | 2594 | 764. | 75.9 | 25% |
| 24 | | | | | | | |
| 8.5 | | | | | | | 50 25% |
| | | | | | | | |
| | 18% | | | | | | 5% 4% |
| | 0% 5% 0% 7% 5% 24 5% 1% | 12.5% 12.5% 44% 77% 44% 77% 25% 25% 25% 25% 25% 25% 20% | 5% 12.5% 12.5% 38% 7% 38% 25% 25% 25% 25% 25% 25% 25% 25% 25% 25 | 5% 12.5% 12.5% 12.5% 25% 25% 25% 25% 25% 25% 25% 25% 25% 2 | 5% 12.5% 12.5% 12.5% 12.5% 12.5% 17% 17% 18% 25% 25% 25% 25% 25% 25% 25% 25% 25% 25 | 5% 12.5% 12.5% 12.5% 12.5% 12.5% 57% 57% 44% 38% 25% 17% 0% 7% 5% 25% 25% 25% 25% 25% 25% 25% 25% 25% | 5% 12.5% 12.5% 12.5% 12.5% 12.5% 12.5% 12.5% 50% 44% 38% 25% 17% 0% 0% 0% 0% 0% 0% 0% 0% 0% 0% 0% 0% 0% |

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

If the same table is worked on the un-depreciated 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) 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 profitability³.

^a 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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| | | | | Returns | THE RESERVE AND ADDRESS OF THE PARTY OF THE | THE RESERVE AND ADDRESS OF THE PERSON NAMED IN COLUMN TWO |
|--|--------------|--------------------------|--|---------|---|---|
| FRoR | 25% | | | | | |
| Cash Flows assumpt | tions at the | time of Inve | stment | | | |
| | Year 0 | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 |
| Cash Outflow | | | | | | |
| Capital | -1500 | | | | | |
| Cash Inflow | | | | | | |
| Profit | | 375 | 375 | 375 | 375 | 375 |
| Depreciation | | 500 | 500 | 500 | 0 | |
| Total Cash Flows | -1500 | 875 | 875 | 875 | 375 | 379 |
| | | | | | | |
| IRR | 43% | | | | | |
| Cash Flows assump | | SED due to / | Vear 2 | Year 3 | Year 4 | Year ! |
| | tions CHANC | The second second second | and the same of th | _ | Year 4 | Year 5 |
| Cash Flows assumpt Cash Outflow Capital | ions CHANC | The second second second | and the same of th | _ | Year 4 | Vear 5 |
| Cash Flows assumpt Cash Outflow Capital Cash Inflow | ions CHANC | Year 1 | Year 2 | Year 3 | | Year 5 |
| Cash Flows assumpt Cash Outflow Capital Cash Inflow Profit | ions CHANC | The second second second | and the same of th | | Year 4 63 | Year 5 |
| Cash Flows assump | ions CHANC | Year 1 | Year 2 | Year 3 | 63 | Year 5 |

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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| (CD1:De | oroviders with softability of Ne | same investi | nents but a | merent stal | ting points | |
|----------------------------|----------------------------------|---------------|-------------|--------------|---------------------------------|---------|
| Particulars | Officability of N | Tariff | Tariff | Tariff | Tariff | Tariff |
| INR'000 | | Year 1 | Year 2 | Year 3 | 1,40 | |
| Year of Operation | | 2 | 3 | 4 | Year 4 | Year 5 |
| RAB for calculating ARR | RAB | 800,000 | | | THE RESERVE THE PERSON NAMED IN | 6 |
| WAS IOL CAICHISTING WAY | RAD | 800,000 | 720,000 | 640,000 | 560,000 | 480,000 |
| Depreciation (Life 10 year | ers) | 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 | 0-0-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:F | Profitability of | Service Provi | der at Brow | nfield Airpo | ort | |
| Particulars | | Tariff | Tariff | Tariff | Tariff | Tariff |
| INR'000 | | Year 1 | Year 2 | Year 3 | Year 4 | 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 year | ars) | 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 | 69,000 | 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 | 1 | 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 i | 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).

