

A Vital Role for the Airports Economic Regulatory Authority



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India's lack of airport regulation has become a severe handicap; a vital role for the AERA

India's airports have suffered from decades of neglect and underinvestment. When the Naresh Chandra Committee presented its report to the Ministry of Civil Aviation in November 2003, it remarked frankly that the country's "passenger airports are for the most part an embarrassment". The inadequacy of the state of airport infrastructure was exposed as air traffic expanded dramatically from 2004 onwards, pushing several metro airports to well beyond their design capacity. Congestion in the terminals, on the runways and in the air, resulted in a deteriorating passenger experience and an increasingly inefficient (and costly) operating environment for the airlines.

Recognising the potential for airport infrastructure constraints to stifle the aviation industry, in 2005 the Government of India announced a USD10 billion airport upgrade and modernisation programme over 5 years to 2010. A further USD20 billion of investment is expected in the following 10 years. Acknowledging that it possesses neither the expertise nor the capital to carry out such an undertaking by itself, the government has invited private sector participation in the process.

But, in order to attract private participation, the first prerequisite is an economic regulatory framework which provides clarity and certainty to investors on the commercial potential of any specific airport operation. The absence of a clear set of guidelines for airport operators ensures that their revenue models remain subject to national debate and controversy. Resources are allocated inappropriately, further reducing investor confidence in future projects, denying India access to critical expertise and capital. The end result is likely to be under-construction – and, ultimately, continued suppression of economic expansion and consumer benefits.

Uncertainty Abounds for Investors

Aeronautical charges currently account for 70-80% of revenue for Indian airports. The revenue potential from this segment is a function of the volume of traffic handled and the charges that can be levied. For an airport bidder or operator seeking to develop cash flow projections, both of these are subject to uncertainty, affecting the ability to arrive at accurate valuations or to determine the ability to fund capital expenditure.

Traffic forecasts in any country are by their very nature subject to many unpredictable market variables. However, in the Indian context this is compounded by the absence of clear policy on critical matters. For example, GMR bid for Delhi Airport on the basis of a policy framework that stated that no competing airport could be developed within a 150km radius, only to subsequently have the Union Cabinet grant in-principle approval for an airport at Greater Noida, just over 70km away. The proposed project has since gone quiet, but had it proceeded the impact on Delhi Airport in the CAPA April 2009: A Vital Role for the Airports Economic Regulatory Authority

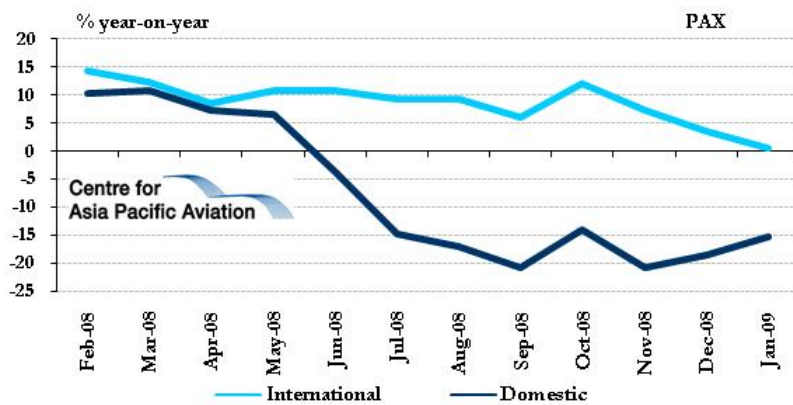
short term would have been significant, altering traffic volumes and patterns, and consequently revenue.

A subsequent Greenfield airport policy introduced in April 2008 states however that the 150km exclusion zone can be waived on a case-by-case basis. The impact on the investment community of such embedded uncertainty is to invite it to go elsewhere.

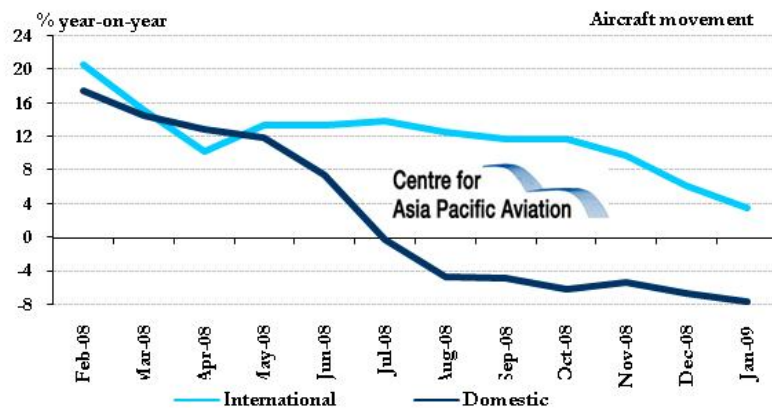
The other key driver of revenue is the charges that can be levied either to airlines in the form of landing, parking and navigation services, or to passengers as service fees.

When Delhi and Mumbai Airports were handed over to public-private joint venture companies, the operators were required to maintain current aeronautical charges for two years. There was no definition of the permissible charging structure thereafter. It had been expected that an economic regulator would have been appointed by then, but that was not the case. Instead, two years later, the combined impact of the fuel price spike and the economic slowdown meant that airline traffic was in decline, and airports were faced with a growing shortfall between their actual revenue collections and their projections which were based on expectations of double digit growth.

AAI passenger numbers growth: Feb-08 to Jan-09



AAI aircraft movements growth: Feb-08 to Jan-09



Source: Centre for Asia Pacific Aviation & AAI

In such circumstances, it is not uncommon for airports to raise charges. But India's private airports did not have the freedom to do so because their operating agreements contain no agreed tariff escalation structure.

The result was anxious negotiations between the airports and governments with a view to raising aeronautical charges, as well as levying User Development Fees at Bangalore and Hyderabad to cover operating shortfalls, and Airport Development Fees at Delhi and Mumbai to fund essential capital expenditure programmes for new terminals.

In the absence of any prescribed guidelines, the process was both untidy and controversial and raised questions for any investor looking at the sector in India towards planning and operating an airport.

The current group of investors entered at a time when it was believed that traffic would continue to grow steeply. Hence revenue was expected to climb and, with an understanding that world standard guidelines would be established, concerns about pricing regulation were overlooked. The current downturn is undoubtedly temporary, however it has highlighted the fact that establishment of an economic regulator is imperative.

Airport Economic Regulatory Authority

The government first stated its intention to establish the Airport Economic Regulatory Authority (AERA) more than 3 years ago. The relevant bill was finally passed in both houses of parliament in late 2008 and the panel was due to be appointed by February 2009. That target has been missed, and with the general election campaign now underway it seems unlikely that the positions will be filled until after the new government is elected.

AERA is to act as an economic regulator for all airports with traffic of more than 1.5 million passengers per annum. There are 11 airports in India which exceed this threshold, representing 85% of passengers handled nationally.

AERA's scope is to set aeronautical charges on a 5 year cycle, taking into account the economic viability of an airport, in line with ICAO principles of transparency, cost-relatedness, non-discrimination and user consultation. This will be based on a determination of the costs of delivering aeronautical services in an efficient manner and to a desired level of service, including both capital expenditure and operating activities.

The regulator will also determine whether User Development and Airport Development Fees are appropriate and will monitor service and quality standards.

The International Experience

The first major airport privatisations were conducted in the UK (with the then British Airports Authority), through an IPO, for "mums and dads" to invest in; and Australia, where airports in the previously corporatised airport system were individually sold in trade sales. In each case, a detailed regulatory system had been installed prior to the sales and each sale also provided a specific "CPI-X" or "RPI-X" (ie. inflation-linked) formula to govern aeronautical price increases over an initial period of up to five years.

After that, the legislated regulator was to have pricing oversight, subject to prescribed guidelines. As they have evolved, these principles seek to strike a compromise between the airports' long term needs to provide for capital expenditures and the airlines' short term requirements. Numerous other countries have since adopted more or less similar systems.

Once the initial closely regulated periods expired, the system of price regulation which has generally been favoured involves "light handed regulation", with requirements for certain levels of performance and the submission of rolling Airport Master Plans for future development.

Australia

Australia offers an example of light-handed regulation. In 2007 the country's Productivity Commission produced a report on what had been an experiment with such an approach to airport pricing control that had lasted five years and was up for review. The report was published just as IATA Director General Giovanni Bisignani singled out some airports, including Sydney, as "monopoly offenders that charge airlines excessive fees, eschewing the 'commercial discipline' that airlines must live by and earning profit margins of over 40%".

Between 1997 and 2003, the 22 airports that were owned and operated by the Federal Government in the corporatised Federal Airports Corporation were individually transferred to private ownership and control through the sale of long-term leases (50 years with an option to renew for a further 49 years). In privatising these airports, the Government recognised that some had significant market power and price regulation was initially imposed.

However, a new light-handed approach was adopted in July 2002 at all Australian capital city and some regional airports. Under this new regime, direct regulatory involvement in price setting was limited merely to the monitoring of aeronautical and related charges at Adelaide, Brisbane, Canberra, Darwin, Melbourne, Perth and Sydney airports. A "dual till" policy was adopted, so that assets used and profits earned in non-aeronautical activities should not be taken into account in determining aeronautical prices.

The airports were put on notice that stricter controls might be re-introduced if they misused their market power.

In 2007, the Productivity Commission reported on the results of the first 5 years of this approach. It stated that against a number of performance indicators the arrangements had measured up well. The light-handed approach had made it easier for airlines and airports to agree on what new investment was required and the charges necessary to pay for it. The removal of the regulator from investment decision-making was viewed as a major advantage, especially as some airports were seeking to embark on major new upgrades.

Recent productivity performance had been high by international standards – suggesting that this was partly due to the less intrusive regulatory approach. Service quality continued to be rated as satisfactory to good by the Australian Competition and Consumer Commission (ACCC). For the larger monitored airports in particular, compliance costs had been quite modest. Finally, at most of the monitored airports commercial relationships between parties had been developing.

The report admitted that airport charges rose substantially immediately prior to, or at the outset of, the light-handed regime. But these increases were either formally approved by the ACCC, or closely followed its regulated pricing 'template'. Since then, increases at most of the monitored airports had been relatively modest, and had often been to pay for security upgrades.

The report argued that, taken together, the charging outcomes had not been outside the boundaries envisaged when the light-handed approach was introduced.

While this light-handed regime had delivered some benefits and price levels that appear not be excessive, problems highlighted were:

- The behaviour of airports as a group with regard to non-price items (e.g. gate allocation and aircraft parking positions) had arguably been less satisfactory;
- Relationships between some airports and airlines had been strained;
- There was little policy guidance on how airport assets should be valued for pricing purposes and there was no clarity as to when further investigation of an airport's conduct should be undertaken.

The report assumed that the effectiveness of the light handed approach in constraining misuse of market power had yet fully to be tested but that the systemic and identified weaknesses in the current framework could be tackled without sacrificing the 'benefits' that the approach had delivered.

It was assumed that as several airports were entering a new phase of the investment cycle, a return to a more heavy-handed regulatory regime could be costly. A key element of the approach was the ultimate threat of re-regulation if there was misuse of power by the airports.

United States

Few airports in the US are privatised. The US method of regulating airport charges is not subject to Federal policy as such and is largely left to local negotiation as it is considered too complex for national enforcement. Indeed, responsible authorities may apply a single or dual till approach to regulation as appropriate to local needs, within the parameter that landing fees must be cost based. Attempts at formulating a national policy in the late 1990s were thwarted when the courts rejected many of the proposals.

The US method of funding airports has been described as convoluted. Commercial airports provide services to aircraft operators and their passengers and they charge airlines, passengers, and vendors accordingly. They can (or at least have been able to) fund large-scale projects like runways or terminals via the capital markets, using long-term revenue bonds.

Many years ago Congress put in place a set of aviation user taxes, dedicating a portion of the revenues to the Aviation Trust Fund, part of whose purpose is to make airport grants. Congress has developed ever more detailed rules for parcelling out these Airport Improvement Program (AIP) grants. About half the annual grant money is reserved for 'discretionary' grants, for which airports must compete.

The only significant change to the system took place in 1990, when Congress allowed commercial-service airports to institute a passenger facility charge (PFC) to fund specific capacity-improvement projects. Of 67 large and medium hubs, only a handful do not currently have a PFC in place.

The move to PFCs and away from AIP grants was a step towards financial self-support. This change also moved US airports closer to the financing model used in other OECD countries, where commercial-service airports are not only self-supporting but generally pay taxes like any other business, whether or not they have been privatised.

United Kingdom

The framework for airport economic regulation has remained unchanged for over 20 years since the Airports Act came into force in 1986, but the UK aviation scene has changed considerably since then with intense local competition between airports outside of the southeast of England, where BAA/Ferrovial currently enjoys near monopoly status, and much greater awareness of competing alternatives among the general public.

The Civil Aviation Authority (CAA) directly or indirectly regulates all aspects of aviation in the UK, while issues such as planning remain with the Department for Transport. The powers available to the CAA as an economic regulator of airports are more limited than those available to other regulators. For example there is no economic operating licence to which a regulator can attach conditions in pursuit of its statutory objectives.

UK airports are subject to three levels of regulatory intervention:

- No specific regulation of the smallest airports;
- The need to hold a "permission to levy airport charges" once an airport exceeds a turnover of GBP1 million in two of the previous three years;
- Designation of certain airports for price control purposes.

The "permission to levy airport charges" turnover threshold has not changed since 1986 and the number of airports required to hold such permission has risen from 22 to over 60.

The highest level of economic regulation applies at those airports that have been designated by the Secretary of State. Since 1986 these have been the three (BAA/Ferrovial) London airports of Heathrow, Gatwick and Stansted, plus Manchester. No new airports have been designated but following a 2007 consultation paper one has been de-designated – Manchester – on the basis of a decline in market power brought about by a much higher degree of local competition now occurring there. By doing so the CAA concluded that the market could provide a better outcome and the price cap was removed. Manchester's de-designation took effect on 01-Apr-09.

At the designated airports the CAA must, after reference to the Competition Commission (CC), set maximum limits on airport charges, usually for fixed periods of five years. It usually does this by applying a formula linked to the retail price index, a measure of inflation.

The CAA is mandated to give due regard to:

- The reasonable interest of users of UK airports;
- The efficient, economic and profitable operation of such airports;
- The encouragement of investment in new facilities;
- Imposition of the *minimum* restrictions that are consistent with the performance of its regulatory functions.

The other major investigation that has taken place recently was the one into BAA's market power in respect of the UK's airports in the southeast of England and Scotland, which was planned before the takeover of that company by the Ferrovial-led consortium. The CAA did not undertake this investigation, rather the Competition Commission did, but the CAA is required to act on the recommendations of the CC. As a result, and subject to appeals that have yet to be made, London Gatwick and Stansted airports, plus one airport in southern Scotland (Glasgow or Edinburgh) must be sold within two years of Mar-09, and none of them to the same buyer or consortium.

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The sale of these airports has occasioned widespread comment from airlines, particularly LCCs like easyJet and Ryanair who believe that an overhaul of the regulatory system was what was required, especially in the arena of *price regulation*.

Other organisations with an input into UK airport regulation are:

- The Office of Fair Trading;
- The European Commission, which can enforce EU competition law where an airport is engaged in anti-competitive practices that have an effect on inter-EU trade.

European Union

The view of the European Commission is that there is a lack of transparency between airport operators and airlines on how airport charges should be calculated and what components should be taken into account in their determination. It notes that most Member States do not possess legislation that regulates airport charges to the satisfaction of both parties, and that disparate charging systems have resulted. After years of airline lobbying the Commission accordingly proposed to issue a Directive that establishes a common framework to regulate the way airport charges are set.

On 15-Jan-08 the European Parliament concluded its first reading on a proposed Directive on airport charges, initially adopted by the European Commission in 2007. While the European Commission proposed to apply the Directive to all airports with more than 1 million passengers per year, the European Parliament increased this figure to 5 million, leaving States the option of applying the Directive to airports below this threshold. There are concerns in some quarters for example about risking costly and damaging over-regulation as well as compromising the ability of European airports to finance much needed infrastructure and capacity development.

European Parliament deliberations are lengthy, but on 11-Mar-09 the EU announced a new Directive on airport charges, which provides a framework for setting airport charges. The European Commission has welcomed the adoption of this new Directive.

According to the EU, the Directive provides "a clear legal framework for setting airport charges and reflects current commercial practices. Once implemented, the new legislation will promote better dialogue between airlines and airports. It is essential to ensure transparency, non-discrimination and appropriate consultation between airlines and airports under an independent regulator in each Member State."

The EU communiqué continued, "Europe's aviation market can also be seen to be leading the world. The recently revised airport charges policy of the International Civil Aviation Organisation has clearly been influenced by the direction the EU is taking, especially on environmental charges."

That said, the EU is notorious for its predilection towards over-regulation and there is unease in some quarters over the likely impact of imposing new and more intrusive rules on systems which have been working reasonably – if not perfectly – well for several years.

Implications for AERA

Numerous other examples exist of privatised airport regulation, but the above offer a spectrum of issues involved.

However, one principle that is common to these and to almost every other country in the world which has privatised any of its airports is: the fundamental - and indeed the sine qua non – of airport privatisation and of attracting private investment is to establish a predictable and transparent regulatory structure relating to pricing and capital development. Without these in place, the prospect of attracting investors diminishes dramatically and, consequently too, any purchase price payable to the government in a trade sale will be reduced accordingly.

At present, the AERA legislation does not contain details of how the authority will enact its power and functions. Once it is established, the new Indian authority has the benefit of what is now a large body of examples and precedents for regulation of privatised airports. It must not miss the opportunity to carefully select from international best practice the most appropriate guidelines.

Among the core issues will be the degree and nature of regulation imposed. As every country is different and because situations vary at different times in global development, there are attractions for establishing a relatively careful initial regulatory structure, in order to establish a system which best meets India's specifics. This would be followed by a prescribed transition to what would probably be a more light handed approach after the initial period expires.

The appointment of the Chairperson and two additional members are critical decisions. It is vital for the sector that they have the appropriate qualifications and understanding to be able to carry out their role in the best interests of all the key stakeholders. That they do so in a clearly independent and transparent manner is of paramount importance.

The role of the AERA in determining the future of the overall aviation sector should not be underestimated. In regulating airports, their decisions also have an impact on airlines, and in due course it may be appropriate to extend the mandate of the economic regulator to include airlines.

As highlighted earlier, the regulatory provisions must be aligned with the overall policy framework of the aviation sector, and in this area the Ministry needs to provide greater clarity. Indeed, until the AERA is established, the Ministry has a key role to play in the interim to ensure that a fair and level playing field exists for all stakeholders.

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