Overview of the framework

Need for a framework

Expansion of the airport network is necessary

Accelerated economic growth, aided by expansion of air services in a competitive environment, has manifested itself in a rapid increase in air traffic. For providing connectivity to regions hitherto not served by commercial flights, it is necessary to expand the network of air services by setting up new airports. Some of the State Governments have already taken steps for setting up greenfield airports. Examples in the past include Cochin, Hyderabad and Bangalore where greenfield airports have been commissioned with the active support and participation of the respective State Governments. The policy relating to setting up of greenfield airports has since been liberalised by the Central Government and several new projects are being planned in different states.

The airport sector has been witnessing significant interest from both domestic as well as foreign investors following the policy initiatives taken by the Central Government to promote Public Private Partnerships (PPP) on Design, Build, Finance, Operate and Transfer (DBFOT) basis. However, the actual inflow of investment has been less than expected, and future prospects will depend on adoption of a comprehensive policy and regulatory framework necessary for addressing the complexities of PPP, and particularly for balancing the interests of users and investors. Moreover, transformation of rules will have to be accompanied by a change in the institutional mindset.

A comprehensive frame-work is a pre-requisite for PPP

For building and operating a greenfield airport on DBFOT basis, a precise policy and regulatory framework is being spelt out in this Model Concession Agreement (MCA). This framework addresses the issues which are typically important for limited recourse financing of infrastructure projects, such as mitigation and unbundling of risks; allocation of risks and rewards; symmetry of obligations between the principal parties; precision and predictability of costs and obligations; reduction of transaction costs; force majeure; and termination. It also addresses other important concerns such as user protection, independent monitoring, dispute resolution and financial support from the Government.

The MCA also lays out a structure for commercialising airports in a planned and phased manner through optimal utilisation of resources on the one hand and adoption of international best practices on the other. The objective is to secure value for public money and provide efficient and cost-effective services to the users.

Elements of financial viability

The four critical elements that determine the financial viability of an airport are concession period; traffic volumes; user fees and other revenues; and capital costs. The concession period for such capital-intensive projects is normally in the range of 50 to 60 years. This timeframe should enable a robust project structure and any further extension in the concession period would improve financial viability only marginally as the present value of projected revenues after 50 years would be very low from the Concessionaire's perspective.

For a greenfield airport, the traffic projections are likely to be conservative as it would take time for traffic to build up. As a result, user fees alone may not provide financial viability, especially since they would have to be kept at affordable levels. Additional revenues can, however, be generated from non-aeronautical sources and real estate development to enable some cross-subsidisation of user fees.

Capital cost is the key element

Three of the four parameters stated above could be virtually taken as given, and as a result capital cost is the variable that will determine the financial viability of an airport project. If the potential for non-aeronautical and real estate revenues is inadequate, bidders may seek an appropriate capital grant/subsidy from the Government in order to reduce their capital investment for arriving at an acceptable rate of return. As such, reduction in capital costs and phasing out some capital expenditure can help improve project viability significantly. Though PPPs undertaken so far in the sector have been financially viable and self-sustaining, the government's initiative to build greenfield airports in remote areas may require cost-efficient designs as well as some capital subsidy.

Technical parameters

Technical parameters will focus on the level of service for the users

Unlike the normal practice of focussing on construction specifications, the technical parameters proposed in the MCA are based mainly on output specifications, as these have a direct bearing on the level of service for users. Only the core requirements of design, construction, operation and maintenance of the airport are to be specified and enough room would be left for the Concessionaire to innovate and add value.

In sum, the framework focuses on the 'what' rather than the 'how' in relation to the delivery of services by the Concessionaire. This would provide the requisite flexibility to the Concessionaire in evolving and adopting cost-effective designs without compromising on the quality of service for users. Cost efficiencies would occur because the shift to output-based specifications would provide the private sector with a greater opportunity to innovate and optimise on designs in a way normally denied to it under conventional input-based procurement specifications.

Performance standards

Performance standards to be enforced

For an airport project, the Concessionaire would not only procure the civil works and equipment, it would also provide various passenger related services as well as cargo handling. The efficiency of its operations would normally be reflected in the quality of service provided to the users. The MCA, therefore, identifies the key performance indicators relating to operation of the aeronautical assets, terminal building, cargo terminal etc., and specifies penalties for failure to achieve the requisite levels of performance, especially in relation to user services.

The MCA includes a Passenger Charter that the Concessionaire should publish and implement for the benefit of users of the airport. This will add to the accountability of the Concessionaire to the users.

Concession period

Concession period to be sixty years

The concession period should normally be long enough to enable the concessionaire to recover its investment with a reasonable rate of return. In the case of a greenfield airport, the traffic build-up may be gradual and the investments in airport infrastructure as well as real estate may take long to recover. As such, a total concession period of 50 to 60 years has been provided. This would enable the Concessionaire to realise the full potential of the project and thus offer a competitive bid. A shorter concession period would require a greater capital subsidy and/ or higher user charges.

The time required for construction of the airport (about two to three years) has been included in the concession period so as to incentivise early completion that would maximise the revenues of the Concessionaire.

Selection of Concessionaire

Competitive bidding on single parameter will be the norm

Selection of the Concessionaire will be based on open competitive bidding. All project parameters such as the concession period, user fees, price indexation, real estate development and technical parameters are to be clearly stated upfront, and short-listed bidders will be required to specify the concession fee that they are willing to offer to the Government. The bidder who offers the highest concession fee should win the contract. In exceptional cases where instead of offering a concession fee, the bidders seek a capital grant/ subsidy from the Government, the bidder who seeks the lowest grant would win the contract.

Concession fee

Concession fee should be levied only if revenue streams can sustain it

Concession fee will be a fixed sum of Re. 1 per annum for the concession period. The Concessionaire shall, commencing from the 20th year of the Concession Period, pay a Premium equal to 1 per cent of the total realisable fee which shall be increased every year by an additional 1 per cent of the total realisable fee. Where bidders do not seek any grant and are willing to offer a higher Premium to the Government and/or an earlier commencement of its payment, they will be free to do so, subject to a ceiling of 40 per cent of the total realisable fee. In case of an exceptionally viable project, the bidders would be free to offer an upfront payment in addition to a share in the fee.

The rationale for the above fee structure is that in the initial years, debt service obligations would entail substantial outflows. Over the years, however, the Concessionaire will have an increasing surplus in its hands on account of the declining debt service on the one hand and rising revenues on the other. Recognising this cash flow pattern, the concession fee to be paid by the Concessionaire will be based on an ascending revenue-share.

Risk allocation

Risk allocation and mitigation is critical to private investment

As an underlying principle, risks have been allocated to the parties that are best suited to manage them. Project risks have, therefore, been assigned to the private sector to the extent it is capable of managing them. The transfer of such risks and responsibilities to the private sector would increase the scope of innovation leading to efficiencies in costs and services.

The commercial and technical risks relating to construction, operation and maintenance are being allocated to the Concessionaire, as it is best suited to manage them. Other commercial risks such as the rate of growth of traffic have also been allocated to the Concessionaire. On the other hand, all direct and indirect political risks are being assigned to the Government.

It is generally recognised that economic growth will have a direct influence on the growth of traffic and that the Concessionaire cannot in any manner influence the rate of economic growth. By way of risk mitigation, the MCA provides for extension of the concession period in the event of a lower than expected growth in traffic. Conversely, the concession period is proposed to be reduced if the traffic growth exceeds the expected level.

The MCA provides for a target traffic growth and stipulates an increase of upto 20 per cent in the concession period if the growth in traffic is less than projected. For example, a shortfall of 6 per cent in the target traffic will lead to extension of the concession period by 9 per cent. On the other hand, a reduction of up to 10 per cent of the concession period is stipulated in the event of a higher than expected growth. For example, an increase of 6 per cent in the target traffic will reduce the concession period by 6 per cent.

Financial close

Project implementation must commence as per agreed timeframe

Unlike other agreements for private infrastructure projects which neither define a time-frame for achieving financial close, nor specify the penal consequences for failure to do so, the MCA stipulates a time limit of 180 days for achieving financial close (extendable for another 120 days on payment of a penalty), failing which the bid security shall be forfeited. By prevalent standards, this is a tight schedule, which is achievable only if all the parameters are well defined and the requisite preparatory work has been undertaken.

The MCA represents a comprehensive framework necessary for enabling financial close within the stipulated period. Adherence to such time schedules will usher in a significant reduction in costs besides ensuring timely provision of the much-needed infrastructure. This approach would also address the typical problem of infrastructure projects not achieving financial close for long periods.

User Fee

Tariffs should be determined with care and precision

A precise mechanism for determination of user fee has been specified for the entire concession period since this would be of fundamental importance in estimating the revenue streams of the project and, therefore, its viability. The user fee shall be based on the rates to be notified by the Government prior to bidding for the contract.

The MCA provides for indexation of the tariffs to the extent of 60 per cent thereof linked to WPI. Since repayment of debt would be substantially neutral to inflation, the said indexation of 60 per cent is considered adequate. A higher level of indexation is not favoured, as that would require the users to pay more when they should be receiving the benefit of a depreciated asset. A higher indexation would also add to uncertainties in the financial projections of the project. In respect of non-aeronautical services, however, the Concessionaire shall be free to determine the charges thereof.

Construction

Handing over possession of at least 90 percent of the required land as well as procuring the environmental clearances are proposed as conditions precedent to be satisfied by the Government before financial close.

The MCA defines the scope of the project with precision in order to enable the Concessionaire to determine its costs and obligations. Additional works may be undertaken within a specified limit, but only if the entire cost thereof is borne by the Government.

Service quality and safety must be ensured

Before commencing the collection of fees, the Concessionaire will be required to subject the airport to specified tests for ensuring compliance with the specifications and standards relating to safety and quality of service for the users.

The Schedules would include the master plan of the airport. The Master Plan should specify the land use and other restrictions on development of the airport and should also earmark vacant land for future expansion of the airport.

Operation and maintenance

Maintenance standards will be enforced strictly

Operation and maintenance of the airport is proposed to be governed by strict standards with a view to ensuring a high level of service for the users, and any violations thereof would attract stiff penalties. In sum, operational performance would be the most important test of service delivery.

The MCA provides for an elaborate and dynamic mechanism to evaluate and upgrade safety requirements on a continuing basis. The MCA also provides for traffic regulation, security and rescue operations.

Reserved Services

Certain services at any airport are to be provided by government agencies. The MCA specifically details the obligations of the Concessionaire in respect of the reserved services with a view to ensuring that the respective agencies are able to provide such services without any obstacles from the Concessionaire.

Right of substitution

Lenders will have the right of substitution

The project assets may not constitute adequate security for lenders. It is the project revenue streams that constitute the mainstay of their security. Lenders would, therefore, require assignment and substitution rights so that the concession can be transferred to another company in the event of failure of the Concessionaire to operate the project successfully. The MCA accordingly provides for such substitution rights.

Force majeure

Concessionaire will be protected against political actions

The MCA contains the requisite provisions for dealing with force majeure events. In particular, it affords protection to the Concessionaire against political actions that may have a material adverse effect on the project.

Termination

In the event of termination, the MCA provides for a compulsory buy-out by the Government, as neither the Concessionaire nor the lenders can use the airport in any other manner for recovering their investments.

Pre-determined termination payments should provide predictability

Termination payments have been quantified precisely as compared to the complex formulations in most agreements relating to private infrastructure projects. Political force majeure and defaults by the Government are proposed to qualify for adequate compensatory payments to the Concessionaire and will thus guard against any discriminatory or arbitrary action by the Government. Further, the project debt would be fully protected by the Government in the event of termination, except for two situations, namely, (a) when termination occurs as a result of default by the Concessionaire, 90 per cent of the debt will be protected, and (b) in the event of non-political force majeure such as Act of God (normally covered by insurance), 90 per cent of the debt not covered by insurance will be protected. However, no termination payment will be due to payable if the Concessionaire fails to commission the project owing to its own default.

A different method of valuation has been adopted for the real estate. It will enable a more transparent and predictable valuation of real estate in the event of termination.

Monitoring and supervision

Independent supervision is essential

Day-to-day interaction between the Government and the Concessionaire has been kept to the bare minimum by following a 'hands-off' approach, and the Government shall be entitled to intervene only in the event of a material default. Checks and balances have, however, been provided for ensuring full accountability of the Concessionaire.

Monitoring and supervision of construction, operation and maintenance is proposed to be undertaken through an Independent Engineer (a qualified firm) that will be selected by the Government through a transparent process. Its independence would provide added comfort to all stakeholders, besides improving the efficiency of project implementation. If required, a public sector consulting firm may discharge the functions of the Independent Engineer.

The MCA provides for a transparent procedure to ensure selection of well-reputed statutory auditors, as they would play a critical role in ensuring financial discipline. As a safeguard, the MCA also provides for appointment of additional or concurrent auditors.

To provide enhanced security to the lenders and greater stability to the project operations, all financial inflows and outflows of the project are proposed to be routed through an escrow account.

Support and guarantees by the Government

Support and guarantees by the Government are essential

By way of comfort to the lenders, loan assistance from the Government has been stipulated for supporting debt service obligations in the event of a revenue shortfall resulting from political force majeure or default by the Government. Guarantees and/ or compensation have also been provided to protect the Concessionaire, though for a limited period, from construction of competing airport which can upset the revenue streams of the project.

Real estate development

Provision for development of real estate by the Concessionaire has been made in the MCA. The Concessionaire can grant sub-licences for the real estate and the same would revert to the Government at the end of the concession period. Real estate in the form of developmental rights over adjacent lands could also be provided for improving project viability.

While allowing sufficient flexibility to the Concessionaire with respect to exploitation of commercial space at the airport, the MCA stipulates some limits and restrictions to prevent excessive commercialisation.

Miscellaneous

An effective dispute resolution mechanism is critical

A regular traffic census and annual survey has been stipulated for keeping track of traffic growth. Sample checks by the Government have also been provided for. As a safeguard against siphoning of revenue share by the Concessionaire, a floor level in present and projected traffic has also been stipulated.

The MCA addresses other important issues such as dispute resolution, suspension of rights, change in law, insurance, defects liability, indemnity, redressal of public grievances and disclosure of project documents.

Application to brownfield projects

The framework contained in the MCA is applicable for development of greenfield airports through PPPs. With some modifications, it can also be applied to brownfield projects involving upgradation and development of existing airports through PPPs.

Conclusion

Private participation should improve efficiencies and reduce costs

Together with the Schedules, the proposed contractual framework addresses the issues that are likely to arise in financing of greenfield airport projects on DBFOT basis. The proposed regulatory and policy framework contained in the MCA is critical for attracting private investment with improved efficiencies and reduced costs, necessary for accelerating growth.