



Cost of Capital

SITUATION

Due to a high proportion of fixed-cost driven infrastructure, the cost of capital of an airport or an air navigation services provider can significantly impact the level of charges. It must be agreed with the airlines and set using fair judgment and transparency. Fair judgment, transparency, consideration of the specific market situation and recent relevant precedent in other regulated industries with independent oversight are key in overcoming the inherent challenges involved in airports and airlines agreeing to the amount for cost of capital.

Airports' and air navigation services providers' (ANSPs) cost of capital determines the rate of return on invested capital and has a significant impact on the level of charges. If the cost of capital is set too high, charges will increase unjustifiably while if it is too low, it discourages investments in infrastructure.

Therefore, the cost base and the rate of return calculation must be made fully transparent to allow an assessment of whether the parameters used are reasonable and that only costs directly linked to the provision of the relevant services are included.

Many models can be used to calculate the rate of return. One of the most often applied models is the Capital Asset Pricing Model (CAPM) to calculate the weighted average cost of capital (WACC). The combination of a company's debt with the cost of its equity gives the WACC:

- ✦ The cost of debt is the sum of the risk-free interest rate and a debt premium. While the former refers to (risk free) government bonds, the latter adds a premium that reflects a creditor's risk when buying a corporate, e.g. an airport's bond, instead of a risk-free government bond.
- ✦ The cost of equity is expressed as the product of a market risk premium and the company's beta added to the risk-free interest rate. The market risk premium is the difference between the (national) equity market return and the risk-free rate. The beta expresses a correlation between the company's specific risk and the market risk and reflects the specific risk of the airport. The result expresses what an investor can expect for its invested capital (the return on equity).
- ✦ The last important element of the WACC is the level of gearing, i.e. debt to equity. As interest paid on debt is generally tax deductible, a certain level of debt, as long as it does not compromise the company's risk in terms of dependency on creditors, will contribute to an optimal capital structure.

Nonetheless, while the methodology to calculate the WACC is straightforward, the determination of the individual values for each parameter of the WACC is often contentious and incorrect setting of parameters can lead to artificially high charges paid by airlines.

IATA POSITION

The rate of return on invested capital in airports and ANSPs must be moderate. As per ICAO's policies on charges, the return on assets to secure efficient financing in capital market should be reasonable. Furthermore, the determination of the individual values for the WACC parameters of an airport or ANSP must be done in consultation with the airlines and be based on the most robust, neutral and accurate information. Fair judgment and recent regulatory precedence, where applicable, must be taken into consideration.

KEY CONSIDERATIONS FOR DETERMINING COST OF CAPITAL

- ✦ The determination of the risk-free rate should reflect the yield of the country's long-term government bonds (tenor of debt should be consistent with the regulatory regime in the corresponding jurisdiction) at the time the deal is done while the debt premium should be determined from strongly rated corporate bonds. Government bonds from countries in financial distress should not be considered for the determination of the risk-free rate.
- ✦ A country's market risk premium should be determined with reference to relevant established regulatory bodies who have considered long-term academic and scientific studies.
- ✦ The determination of the beta for an airport or an ANSP must reflect the low risk of these companies. As a consequence, the beta should be near the beta value of utility companies. When using a comparative approach, it needs to be ensured that the comparator companies are of a similar structure, regulatory regime, legal and tax jurisdiction, region and financial and operating risk profile.
- ✦ An optimal level of gearing should be used in determining the cost of capital. A company's current gearing may not reflect its optimal financing cost.