

## Session 8:

# Calculating the Overall Charges Level (Panel Discussion)





## Objective:

To highlight the different factors taken into consideration while setting user charges (ex. Building blocks, inflation, currency fluctuation) for the different types of charges (Airport, ANS, MET) and address the challenges associated with the information retrieval and coordination faced by the service providers, discuss them, exchange ideas and practices. Also to present best practices and discuss specific challenges related to the determination of MET charges, safety oversight and regulatory Authorities share in the Airport and Air Navigation charges, etc.



## Information retrieval and report creation



## Which information is required?

The building block information needs accurate determination.



## Dimensions of information to be discussed

In order to comprehend and agree, information has to be looked at from different dimensions:

- 1: Segmentation of costs – cost structure (**What cost**).
- 2: Value for each cost element (**How much**).
- 3: Development of cost over time – time dimension (**When**).
- 4: Comparison of cost development over time – plan versus actuals (**What difference**).

→ The time dimension is important and should be made available from reporting systems.





## Difficulty of information management

All companies around the world at some point have difficulties in understanding their own information. Why?

1. Information systems, ERP (enterprise resource planning) and databases are only as good as they have been implemented and as they are fed with information.
2. Inaccurate data in – inaccurate data out.
3. System changes or enhancements can result in a break with historical data.
4. Retrieval routines are default settings with customization creating problems afterwards.
5. Organizational changes are not always reflected in information management systems.

## Retrieving opex information: Chart of accounts

Where to start?

Information regarding costs and revenues is always available – it is part of the annual auditing process.

The best way to start is to review the chart of accounts and budget plans.





## Chart of accounts captures information in detail

- The 1<sup>st</sup> dimension is the structure of how cost is organized in the company – typically the chart of accounts .
  - The same structure is used for budget planning – the estimation of costs for the next period.
  - Both information should be easily available within the organization.
- 
- To start gathering information, we focus on the Accounting/Finance department and extract year end closing information, closed historical years, current year budget / versus actuals/forecasts, planned budgets for the following years (if existing).
- 
- Caution: Changes in the account structure may lead to “historical” breaks (disruptions).





## Structured information on opex

2015      2016      2017      2018      2019      2020

Salaries and related

Pension

Travel

Maintenance

Consulting

Rent

Depreciation

**Total Cost**

Category	2015	2016	2017	2018	2019	2020
Salaries and related	1,200,000	1,300,000	1,400,000	1,500,000	1,600,000	1,700,000
Pension	100,000	110,000	120,000	130,000	140,000	150,000
Travel	50,000	55,000	60,000	65,000	70,000	75,000
Maintenance	80,000	85,000	90,000	95,000	100,000	105,000
Consulting	120,000	130,000	140,000	150,000	160,000	170,000
Rent	150,000	160,000	170,000	180,000	190,000	200,000
Depreciation	200,000	210,000	220,000	230,000	240,000	250,000
<b>Total Cost</b>	<b>1,800,000</b>	<b>1,950,000</b>	<b>2,100,000</b>	<b>2,250,000</b>	<b>2,400,000</b>	<b>2,550,000</b>

## Discussing opex for a meaningful consultation

Why and how is this information relevant:

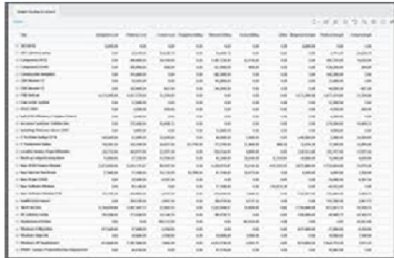
- To understand historical cost developments.
- To know the reasons why.
- To discuss how cost development can be optimized.
- To understand trends and plan future cost and staffing.

In addition, the staffing development needs to be shown and explained.

It is essential that airlines understand charges and that discussing the approach towards them is indicator of a trusted partnership.

Confidential information can be addressed via a *Non Disclosure Agreement*.

	2012	2013	2014	2015	2016	2017
<b>Salaries and related</b>						
<b>Pension</b>						
<b>Travel</b>						
<b>Maintenance</b>						
<b>Consulting</b>						
<b>Rent</b>						
<b>Depreciation</b>						
<b>Total Cost</b>						



## Building Block identification: Depreciation

Depreciation is an important building block:

The expense for an investment is covered in the charges calculation as a cost for the portion of each year the asset can be used until it is fully depreciated.

This portion is treated as a cost in the charges determination calculation and set into perspective to traffic for the unit rate determination.



Where is this information?



Asset register of the company.

## Follow the money: Forecasting revenue development

Payments from charges and commercial/other activities are captured in the company's accounting system. They are primarily a reflection of traffic development.

Traffic information should be available from billing processes. Equally important is the effort by the company to forecast future traffic: this exercise is typically part of the budget planning.



The financial result of the company will be determined for the past, present and future from these same sources of information.

## Conclusion: Accessing and organizing information

All information should be accessible and available from company databases (Finance / Accounting).

To provide transparency for the consultation, this information should be structured and shared.

Variances over time should be proactively addressed and explained.

Jumping costs are always requiring an explanation.



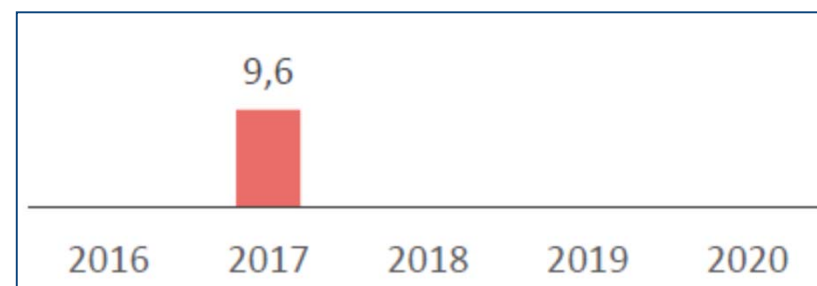


Consulting on investments

## Investment plan reviews

Planned investments need to provide the following answers:

- Description.
- Justification.
- Alternatives.
- Amount & financing.
- Asset life.
- Spending period.
- Planned and actual user engagement.
- Trigger for investments.



## Users need to be allowed to challenge investments

A collaborative approach towards investments gives users the possibility to challenge the necessity of some investments.

### **That means:**

- 1) Are the investments justified or necessary?
- 2) Are they required at the time proposed or can they be postponed?
- 3) Are they required in the proposed scope or can the scope be adjusted?
- 4) Are further investments necessary or need to be planned for?
- 5) Are investments aligned with traffic forecasts?





## Benefits of discussing investments openly

- Investments in aviation infrastructure are cost intensive and have a long life cycle.
- They need to be adequate to deliver future services and reflect future demand (traffic development).
- Users are driving the traffic and are the ones using the infrastructure – they know what they need.
- Users can only pay for what they use – infrastructure needs to be adequate to demand.
- Discussing investments openly with users will avoid sunk costs in assets which are not being used or used sufficiently.
- Airlines may request more investments if necessary.
- Charges negotiations are facilitated if investments are agreed – Master Plans.



## Information about investments

Information about the major investments can be structured in an easy way.

Name and description

Purpose and risk

Total cost

Completion Year

Funding sources

Years of use

Opex cost impact

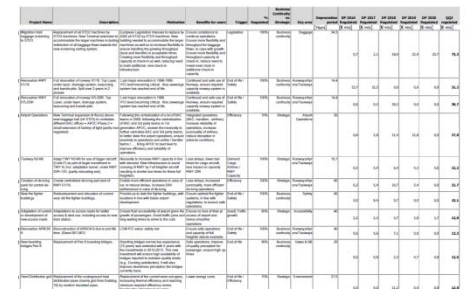
Impact on charges



Information is easily displayed in an Excel file.

→ The file can be send in advance before the consultation.

→ Content to be discussed during the consultation.





Multi-Year charges periods and other important factors in the charges calculation

## Charges can be set for one or for many years

- The building block model allows charges to be calculated for the next year or for several future years.
- Once the values for cost and revenues are clearly determined and discussed, the calculation of the development of the charges level is a simple exercise.

But: Some things are different and need to be understood.





## The first year is different from the last year

### What may change?

- In a 5 year agreement, the plan for the next year is not a difficult exercise but who knows what is in 5 years?
- A volatile global economy can not predict what traffic (= revenues) will look like in 5 years from today.
- Cost development is also dependent on the development of the local cost structure: pay rises can be different in 5 years than today.
- Exchange rates may influence the profitability and the revenues in a significant way – but who knows how they will develop?
- The politics of neighboring countries, war zones, economic crises etc. could have an impact in the future.

In conclusion: the future is not (well) known.

## Multi year agreements require more consultation time

- In multi-year charges agreements, a multi-year cost and revenue overview needs to be prepared and discussed.
- This will have to show the historical, current period's cost and the planned cost for the new period.
- ➔ It is important to understand information on historical actual cost versus planned cost. This comparison provides an idea of the previous year's planning potential and accuracy.
- As a result for unknown developments, there is a natural tendency to plan for contingencies the more the plan leads into the future!



## Some regulations prescribe multi-year agreements

- 1) In some European countries as well as in South Africa, existing regulation demands that the agreement is made for a multi year period.
- 2) These approaches require a multitude of meetings and often intense discussions about assumptions, forecasts, plans and investment proposals.
- 3) Often, agreement is not found and the situation is escalated to the state (regulator, ministry).
- 4) Concession contracts often provide another level of contentious debate.
- 5) From experience, multi year agreements can save a sufficient amount of time if implemented with some flexibility. Charges are then determined and predictable for the agreed period.

## Pros and cons of multi-year agreements

### Pros

- Consistent framework.
- Predictable development.
- Planning certainty.
- Less effort once in place.
- Focus on the business.
- Efficient.

### Cons

- Very time consuming.
- Dealing with uncertainty.
- Forecasting challenges.
- Limited flexibility.
- Approach towards risk.
- Contentious debates – trust.



## A combination may be the solution

The benefits of multi-year agreements may be achieved in a transition period.

- In order to build trust, consultations could start in full transparency for a one year charges period.
- After two successful rounds of consultations (we are in year 3), plan for a workshop to discuss a multi-year framework.
- Work along the pros and cons: it is important that the framework is defined independent of the people in charge!
  - Why? → People may change and support for the agreement may change, therefore it needs to be robust to be kept in place.
- Envisage how to deal with challenges, e.g. in the global economy.
- Prepare for annual reviews and build in flexibility.





## Multi-year agreements require more information

Transparency about historical, current and planned data is essential.

What needs to be reviewed:

Development / data on: Traffic, Revenue, Cost, Staff, Investments.

Over more years than in a single year agreement. Displayed as:

- Historical Data.
- Current year plan.
- Current year forecast
- Future year plan.
- Each available year planned data and actual data.



## Alignment and agreement is the foundation

- The foundation for a strong and trusting partnership is sharing of information.
- Airlines need to understand why the product that they buy should have a certain price.
- Providing information may be difficult – a collaborative workshop to understand where to look and what to look for will help.
- Allowing to discuss information openly will help all sides: users have ideas that will benefit not only themselves.
- A strong partnership is the basis for mutual success!

## External factors can profoundly influence cost/revenues

The cost and revenue situation of a company can be profoundly different if each is calculated in different currencies.

The company's cost base is fundamentally in the country's currency.

Most expenses are paid in local currency apart from some foreign purchases e.g. investment goods.

The company needs to have its funds in sufficient local currency to pay its ongoing expenses.

The financial reporting is usually also done in local currency.



## Exchange rate fluctuations impact the financial situation

When the local currency is volatile on foreign exchange markets, revenues will also fluctuate due to exchange rate variations.

### A common situation:

- Costs are paid in local currency – revenues are received in foreign currencies.
- If the local currency fluctuates, the revenues exchanged from foreign to local currency fluctuate as well.
- Volatile home currencies often devalue against a stronger charging currency.
- Should this happen over the charges period, the result is positive for the company.



## Positive effects of currency fluctuations

### Example: Revenues in USD

- ↗ Exchange rate 1 USD to 1 LEP (Lemurian Peso) = 2.5.
- ↗ For 1,000 USD the company receives 2,500 LEP.
- ↗ Now the USD gains in value: 1 USD buys 3.5 LEP.
- ↗ The 1,000 USD revenue are now suddenly 3,500 LEP – without anything else.

With regards to foreign exchange (forex), the revenue of the company increases due to the increase of the USD.



## Negative effects of currency fluctuations

**But there is no free lunch anywhere.**

If the other currency rises, your currency has fallen.

This makes your imports more expensive – like investments only purchased abroad or energy - oil is traded in USD etc.

Currency fluctuations can be contained by using financial instruments such as hedging. But such instruments come at a cost and should be validated if useful.





## Charges may not have to be changed over a long time

Why does this not automatically justify an increase in the charges level?

- The company's cost may have risen and there could be a demand to increase charges as well to compensate.
- But higher revenue also comes from traffic growth – more traffic – more revenue from charges (costs typically do not rise in the same proportion).
- Another important revenue contributor is the exchange rate: if the local currency has devalued and revenues are collected in a stronger currency – there is a windfall profit.

In retrospect, we often even can conclude:

- In previous periods, due to above effects, charges should have even been lowered but did not as no consultations took place.
- Considering above factors, even today charges could probably fall.



## Increases in inflation can shift the cost base upwards

- In many regulated environments, the tariff formula uses inflation.
- Inflation is in simple terms a definition for the price development of a basket of goods and services.
- The determination is standardized and officially published by the country's statistics or any other office (also available from IMF data).
- It is therefore an official figure to indicate how prices have developed.
- The office also forecasts how it sees prices will develop: the inflation expectation.



## Planning charges by simply adding inflation is not correct

We observe sometimes that in multi year periods that today's cost is simply forecasted to increase with future inflation.

Yet the company's cost is not a reflection of the basket that determines inflation. The impact of high inflation rates thus can become extraordinary:

### **For example:**

Inflation rate 2018 = 5%, 2019 = 8%, 2020 = 7%

Cost base opex 2017 = 25,000,000

Cost increases due to inflation:

$((25,000,000 * 1.05) * 1.08) * 1.07 = 30,334,500.$

→ Without any new services or increased staff etc. the cost has gone from 25 Mio to over 30 Mio in three years just by applying the expected inflation rates!

## How to address inflation in charges?

The best approach to address the concept of inflation in a charges calculation is  
→ Not To Do It.

Instead: Make a realistic plan and forecast.

- Investments can not be planned with a simple inflation adjustment.
- The country's inflation rate measures a basket of goods and services – these are mostly irrelevant for the company. The only valid component is staff cost.
- A realistic plan shall address all relevant parameters to plan the development of future cost for: Staff, Maintenance, Utilities, Consulting, Efficiencies etc.
- The company has large bargaining powers to get better prices.
- That is typically the value added of the procurement department and the justification for its existence.

## Conclusion: A collaborative approach means win-win

- ✓ Each side has an interest in the financial well-being of the other.
- ✓ Understanding each other's perspective develops trust.
- ✓ It is not about who takes the bigger piece of the cake but to increase the size of the overall cake.
- ✓ The partnership will be tested in rough times – and a good partnership will always survive and grow.



But planning is not always easy ...





In practical application:

The calculation of the overall charges level



## Calculating the overall charges level

The incorporation of all relevant charges determination aspects drive the calculation of an annual charges level:

Total reasonable cost.

Total traffic estimates.

Total revenues.

Expected exchange rate development.

= Charge per unit (can be broken down into a structure of charges).

Proof: The multiplication of the charge per unit with the forecasted traffic units should result in the total cost of the company – which it should finance.

Financial Modeling will determine %-changes of that base for every year in a multi-year agreement.



## Application of the charges level

The calculation is for a minimum done to cover three years:

1x for the last available period with actual data (last year).

1x for the current year.

1x for the next year`s charges period.

The revenue of the company as per building block methodology is compared with the effective revenue generated in each year.

A percentage difference is calculated to reflect any potential difference.

The development of revenue per PAX as a percentage is applied on the future charges level considering any deviation of effective to allowed revenue.





## Example to calculate the charges level

For the next period, the total cost is set into perspective to the total traffic to calculate a revenue per PAX.

Based on actual data, forecast and plan, the calculation shows that overall charges levels should fall by 2% in the next period to reach the required revenue.

YEAR	2017	2018 Forecast	2019 Plan
<b>Opex</b>	1,355,000,000	1,370,000,000	1,380,000,000
<b>Depreciation</b>	450,000,000	465,000,000	475,000,000
<b>Cost of capital</b>	26,000,000	27,000,000	28,000,000
<b>Total cost</b>	1,831,000,000	1,862,000,000	1,883,000,000
<b>Other Revenue</b>	(12,000,000)	(14,000,000)	(16,500,000)
<b>Allowed Revenue</b>	<b>1,819,000,000</b>	<b>1,848,000,000</b>	<b>1,866,500,000</b>
<b>Total PAX</b>	12,350,000	12,680,000	13,100,000
<b>Revenue per PAX</b>	147	146	142
<b>in %</b>		-1.05%	-2.24%



## Excel-based calculation example:

### The impact of traffic forecast and opex planning

YEAR	2017	2018 Forecast	2019 Plan
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## Transforming the calculated unit rate into the structure of charges

This document sets out Manchester Airport Plc's Terms & Conditions of Use ('the Terms') and the Charges that will apply from 1 April 2018 to 31 March 2019 ('the Period') unless the users are notified otherwise by Manchester Airport Plc. This edition replaces the 2017/2018 edition.

The provisions in Sections 1 to 12 inclusive are strictly subject to the Terms contained in Sections 13 to 16 inclusive.

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The total calculated allowed revenue per PAX (or any other unit) shows the percentage difference over the previous period. In other words, with the new percentage applied over the previous value, the result is a new revenue per PAX which in multiplication with the forecasted number of PAX yields the allowed revenue.

The percentage can be applied over all charges and a detailed revenue calculation then shows if fine-tuning is necessary.



**THANK YOU**