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An Aviation Agenda for the next Indian Government

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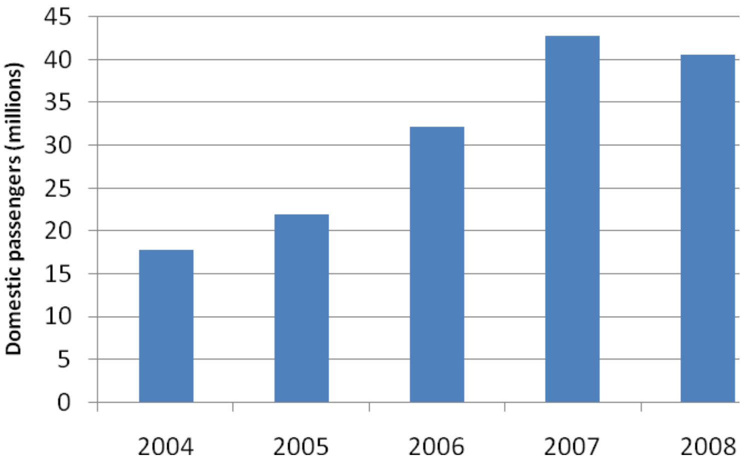
An Aviation Agenda for the Next Indian Government

India's general election is drawing to a close, with counting to be completed by 16 May 2009. This mammoth logistical exercise, involving an electorate of more than 700 million, will determine the make-up of the next government that will lead the world's second most populous nation. The fractured nature of Indian politics means that the outcome is still unclear. But one thing is certain, the new Minister of Civil Aviation will have a busy agenda ahead.

The Last Five Years

The current government, after setting a blistering pace in aviation sector reform during the first half of its term, lost momentum in the last couple of years, during which more could have been achieved. The first three years of Civil Aviation Minister, Praful Patel's tenure were remarkable, and the speed and direction of change was unlike anything that India has seen before.

Domestic Air Passenger Traffic 2004-2008



Source: DGCA, CAPA

Genuine deregulation of the domestic skies; liberal bilateral agreements with all key markets, including open skies with the US; modernisation of Delhi / Mumbai airports; fleet purchase orders and a merger of the national carriers; allowing domestic airlines to fly overseas; open skies in cargo and many other initiatives created a solid platform for further growth and for the development of a world class aviation industry in India.

This initial burst ideally needed to be strengthened by further reforms and policy initiatives. Instead, the pace slackened and several important issues were left unaddressed, in particular:

- the New Civil Aviation Policy;
- Foreign Direct Investment regulations in the airline sector;
- abolition of the 5 year/20 aircraft rule to allow more private airlines to fly international;
- delays in setting up the Aviation Economic Regulatory Authority;
- city side development of non-metro airports;
- postponement of the ground handling policy;
- under investment in ATM and CNS infrastructure;

- under-resourcing of the DGCA which has resulted in India receiving a warning that it may be downgraded by the US to a Category 2 nation, due to deficiencies in the safety oversight mechanism.

The disappointment of the last couple of years is in large part driven by the expectations set by the first three years, which were genuinely historic in their impact on the industry. The political environment in India can make it difficult for such momentum to be sustained.

The new government will take charge at a time when the aviation industry is faced with an extremely challenging environment on many fronts. However, a number of key issues which require urgent attention include:

- Securing the future of Air India;
- Ensuring that airlines have adequate access to capital;
- Establishing an economic regulator for airports;
- Moving ahead with the development of second airport in Mumbai;
- Allowing Indian carriers to compete on international routes.

Where to next for the Maharajah?

The new administration's most urgent priority will be to focus on the future of Air India. The national carrier is facing perhaps its toughest ever crisis, with losses for the 12 months ended 31 March 2009 estimated to be in excess of USD800 million. Mr Raghu Menon, Chairman and Managing Director, was recently removed after just 12 months in the role, reflecting the sorry state of governance at Air India. In fact, his departure has been mooted almost since he first took on the position.

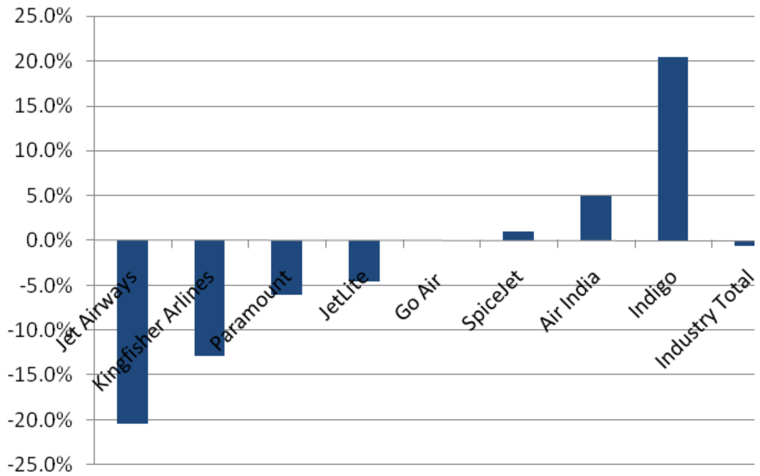
Apart from the external environment, much of Air India's current troubles stem from the mis-handling of the merger between Air India and Indian Airlines. This marriage between the international and domestic state-owned carriers made perfect sense on paper, but has been let down by poor execution. As a result, the merged entity is directionless and company morale is at a low. Aircraft utilisation remains poor, yields and load factors are both in decline, with no corresponding reduction in the cost structure. To prop-up its weakening position, Air India has amassed debt of approximately USD4 billion.

Air India Domestic Market Share since January 2004

Source: DGCA, CAPA

In terms of rightsizing capacity in line with the reduction in demand, Air India appears to be in self-denial, with no change to its plans to take delivery of 26 aircraft during the current financial year, including 19 A320 family aircraft and seven B777s. No more than seven aircraft are expected to be retired during the same period (partly due unfavourable return conditions on a number of aircraft on lease or sale-and-lease back), resulting in a significant augmentation in capacity when the opposite would be more appropriate.

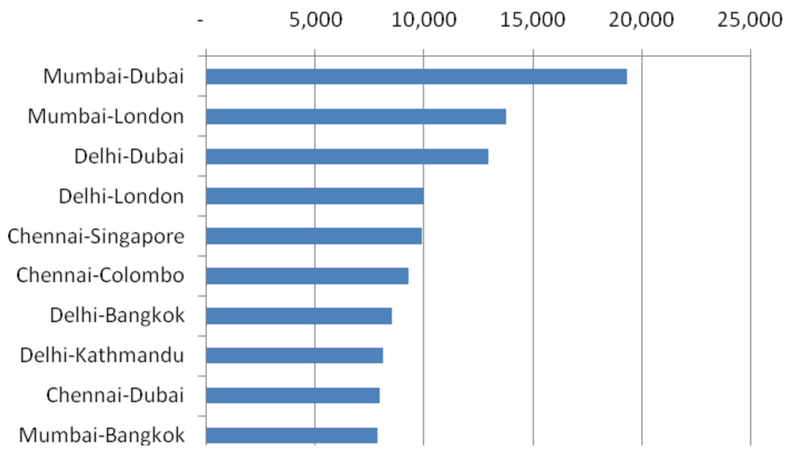
Domestic Capacity Change May 2009 v May 2008



Source: DGCA, CAPA

The planned induction of seven longhaul aircraft when the international market is softening when Air India is already struggling on the Europe and North America routes is surprising. The aggressive expansion of Gulf carriers in the Indian market will continue to increase competitive pressure on Westbound international services in particular. Jet Airways and Kingfisher have both responded to market conditions by putting their international expansion plans on hold. Jet Airways has also sub-leased a number of longhaul aircraft.

Top 10 International City Pairs ex India by Weekly Capacity May-09



Source: OAG, CAPA

Air India has changed its longhaul strategy mid-stream. The long range B777s were acquired in order to operate non-stop services to the US, however the airline has recently announced plans to establish a hub in

Frankfurt over which to connect one-stop services between India and North America.

The delay in establishing a common technology platform which can be integrated with partner carriers means that Air India's accession to the Star Alliance is likely to be further delayed. The selection process for the technology vendor is currently under investigation by the Central Vigilance Commission and it is unclear how long this may take. This is a serious setback as membership of a global alliance would have significantly enhanced feed for Air India.

Meanwhile, the plan to establish a dedicated cargo subsidiary has proven to be a non-starter. The joint venture agreement with logistics company, GATI, has lapsed and only a single A310 is operating in freighter configuration.

Air India's newly appointed Chairman and Managing Director, Mr Arvind Jadhav, has a tough task ahead. The airline is struggling to carve out a role under government ownership and the next administration needs to start work on preparing a roadmap for privatisation of the carrier. Establishing special business units in cargo, ground handling and maintenance and hiving them off will help unlock value, if properly implemented, but special attention needs to be given to the core business of flying.

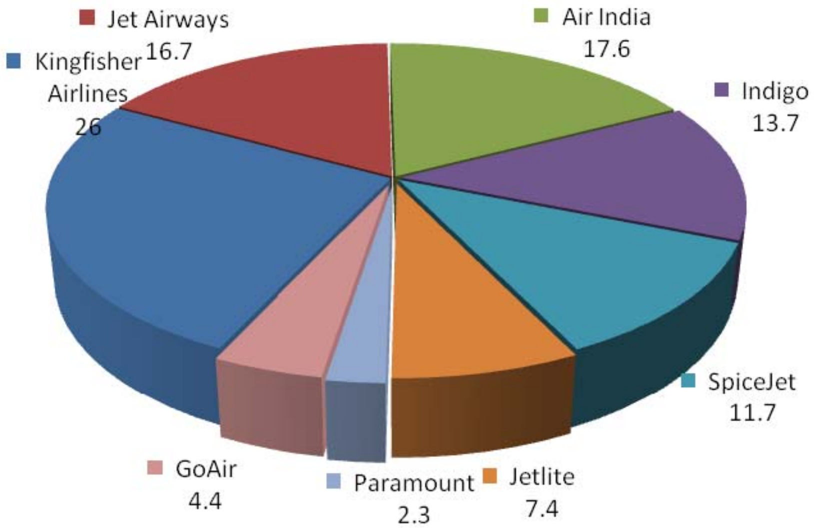
Continued delay will be costly and CAPA strongly recommends privatisation of Air India within the next two years. In preparation for this, the government must strengthen the Board with experienced independent directors, having global credentials and a proven and strategic understanding of the aviation business. A functional CEO or COO, with a strong airline industry background, needs to be recruited under the Chairman and Managing Director. Ultimately, the carrier needs a new business plan with a clear strategic outlook and radical restructuring of its operations and organisational capabilities.

The airline industry fights for survival

Air India's malaise is but one element of a financial crisis facing the wider Indian airline industry. Industry net losses for the 12 months ended 31 March 2009 are expected to be in the region of USD1.3-1.4 billion. As a benchmark, IATA estimates that the combined net losses of airlines globally for 2008 at USD8.5 billion – India's contribution to this is significantly higher than the 2% of world air traffic for which it accounts.

The market debt of the three major airline groups – Air India, Jet Airways and Kingfisher Airlines – currently stands at USD8 billion and could reach USD10 billion by the end of the current financial year (equivalent to up to 1% of India's GDP). The huge interest burden this creates at a time of declining revenue is weighing heavily on these carriers. CAPA believes that the Indian market is not large enough to support three large full service carriers operating and competing on similar footprints, and that rationalisation is inevitable and desirable for the health of the industry.

Domestic Airline Market Share April 2009



Source: DGCA, CAPA

The over-aggressive expansion of the big three carriers is partly responsible for the fiscal demise of the sector, however some blame can also be apportioned to the structural costs facing the industry in the form of high taxation and inadequate infrastructure. It is unfortunate that the airport modernisation program currently underway may itself suffer if airport revenues continue to fall below projections due to the contraction in traffic.

Indian banks and financial institutions now have significant exposure to the aviation sector and it is uncertain how much more they will be willing to take. With local sources of capital drying up, the ability to tap foreign investors will be key to the survival of several airlines over the next 12-18 months. The new administration should take the long awaited step of permitting foreign airlines to take a strategic investment of up to 49% in Indian carriers. It is imperative that the airline industry be turned around to a position of viability and the new government must take effective measures to address this issue.

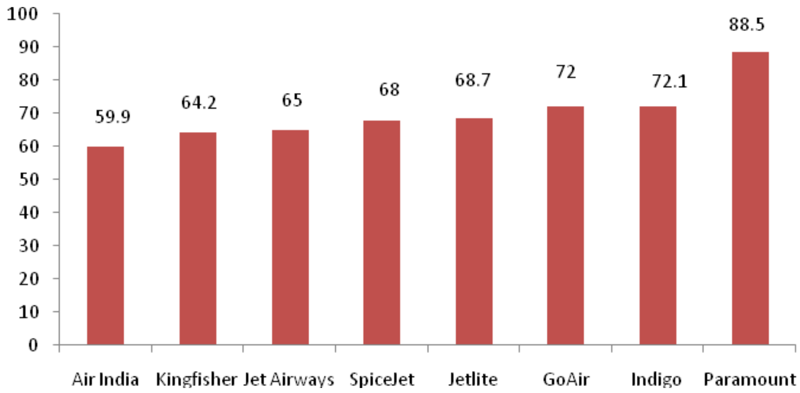
The Future for Low Cost in India

While the government has a role to play, the airlines themselves must also identify a viable model for the markets in which they operate. Recent developments suggest that they are still struggling with this. Jet Airways' launch of a new no-frills brand this week, Jet Konnect, and Kingfisher's plans to transfer more routes to all-economy configuration aircraft, are an admission of the fact that the full service model has limited potential beyond the six major metropolitan cities and that domestic market growth will be driven by the availability of affordable fares.

However, both carriers are planning to offer lower fares within the cost structure of the full service operation, rather than as standalone subsidiaries, a move which may lead to further damage to their profitability. This trend towards all-economy product comes just a couple of weeks after Air India had announced that it was considering the possibility of introducing premium economy on domestic services for a three class configuration, in sharp contrast to the global trend.

In April 2009, the number of domestic passengers declined by 591,000 or 15.2% year-on-year, and 86.7% of this decline was accounted for by Jet Airways and Kingfisher Airlines. Full service carriers have also been reporting the lowest passenger load factors recently.

Domestic Passenger Load Factors (%) April 2009



Source: DGCA, CAPA

The fact is that despite the operational challenges, the low cost model is ideally suited to the Indian market, which requires safe, reliable and affordable alternatives to slow and uncomfortable surface modes of travel. To have the greatest positive impact on national development and connectivity, the government must encourage the growth of LCCs.

The financial performance of low cost airlines in the last two quarters has further shown that the model has the potential to break even on a cash basis from 3Q 2009/10. Industry sources suggest that a greater proportion of corporate traffic is travelling with LCCs as they extend their route networks, establish a reputation for punctuality and as the economic downturn leads to corporate travel policies requiring airline selection based on “best fare of the day”.

CAPA expects that if oil prices average USD50 per barrel and non-fuel expenses remain stable, low cost airlines could return to profitability by the end of the current financial year. This process could be accelerated if LCCs were more aggressive and innovative in developing ancillary revenues which have not been yet been leveraged to their full potential. Increasing aircraft utilisation would also drive further cost reductions, and may now be possible due to reduced congestion at metro airports. Despite the more encouraging outlook for LCCs, CAPA believes that consolidation is critical amongst low cost airlines over the next few months to ensure long term growth and profitability.

Regulation of Airports

In order to build a modern, world class airport system in India, almost USD30 billion of investment will need to have been committed in the 15 years through to 2020. The government acknowledges the important role of the private sector, but in order to attract its 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. India's airport modernisation program is at a critical phase, particularly at the two premier gateways, Delhi and Mumbai, over the next 12-18 months, and ensuring airport pricing transparency will be extremely important at this time.

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 AERA. In order to avoid further inefficiencies in capital allocation, it is imperative that the new government addresses the establishment of AERA as a matter of urgency.

Navi Mumbai Airport

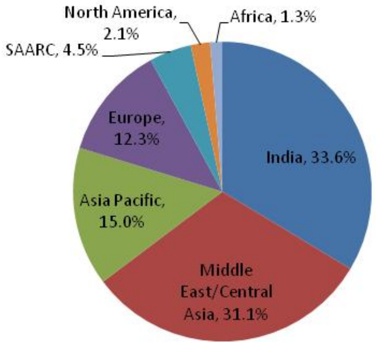
Mumbai is India's commercial capital and home to the country's largest airport. An airport, which as a result of its location is space constrained and will soon reach a point beyond which its capacity can no longer be expanded. Without the construction of a second airport, the city's global competitiveness as India's financial hub will be threatened.

Plans for a greenfield airport at Navi Mumbai, the new growth centre of the metropolitan region, have been approved, however tenders have yet to be issued for development of the new facility. A decision to proceed must follow imminently if Mumbai is to avoid running out of airport capacity in the next five years.

Bilateral Agreements

The current administration has pursued a very liberal stance on bilateral air services agreements, taking into account India's economic, political and strategic requirements. However, it may be time to reflect on the issue of market access and to ensure that India's carriers are able to effectively leverage the international market potential that exists. With Indian airlines suffering huge financial losses, their expansion plans are on hold, while a number of foreign carriers continue to expand aggressively into India and claim market share.

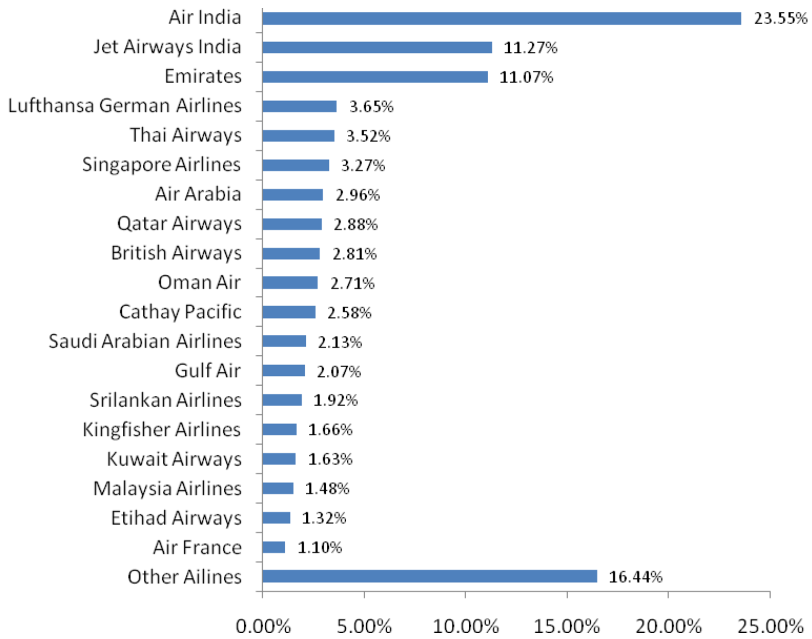
International Market Share to/from India by Region of Airline Origin



Source: OAG, CAPA

At the same time, some domestic airlines are prevented from operating international services due to the regulation which requires Indian carriers to have been in operation for at least five years and have a fleet of more than 20 aircraft to be granted international rights. The same restriction does not apply to foreign airlines that operate into the country, and unfairly discriminates against Indian carriers. It is time for this to be lifted.

Top 20 Airlines by International Capacity Share February 2009



Source: OAG, CAPA

Other issues for the government to consider include:

- **Civil Aviation Policy:** Although frequently promised, there has not been a formal civil aviation policy since 1993. The industry is expected to attract investment of over USD120 billion by 2020 and it is important for the growing importance of aviation to be recognised with the ratification of a sectoral policy;

- **Restructuring of the Ministry:** As aviation becomes an increasingly important sector of the Indian economy, consideration must be given to developing an aviation policy and governance framework that is aligned with the needs of the industry. The focus should be on creating an environment that is equitable, efficient, transparent and in the national interest. At present the Ministry of Civil Aviation is responsible for both policy formulation and regulation. A possible alternative model to follow would be the UK Civil Aviation Authority which is funded by the key stakeholders in the industry, is responsible for both technical and economic regulation, and rather than being a civil service department, is run independently by the leading specialists in their field. Such an approach would relieve the Ministry of Civil Aviation of its regulatory responsibilities, allowing it to focus on policy development to facilitate long term growth

- **Renewed Focus on Safety:** The Directorate General of Civil Aviation needs to be adequately resourced and trained to focus on technical regulation, with a strengthened capability in managing safety and air worthiness, and the ability to act in an independent and transparent manner. Indian aviation must have safety as a paramount objective. Apart from being an ideal in its own right, it is essential for the long term growth and reputation of the industry, the country can ill afford a mishap at this nascent stage of its development. The recent warning from the FAA regarding its concerns about the safety oversight mechanisms in India should act as a catalyst for addressing this issue;

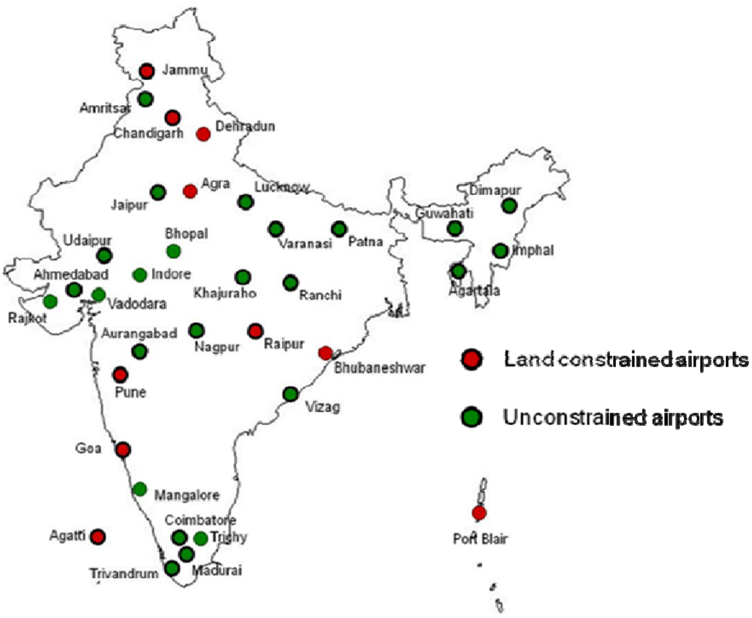
- **Corporatisation of Air Traffic Management:** There has been underinvestment in airspace issues in India with implications for both safety and efficiency. Implementation of a more accountable corporate structure would assist in supporting investment and improved performance;

- **Role of Government Organisations:** As the private sector become increasingly active in both airline and airport operations, it is important to outline a long term plan for the role of state-owned organisations such as Air India and the Airports Authority of India;

- **Airport Modernisation:** Embarking on the airport modernisation program was a major success of the current administration, however it is important that the momentum be sustained and not reduced as a result of the market slow down. The fact that the AAI plans to raise approximately USD1 billion is encouraging.

  But there needs to be greater coordination between the states and central government to plan airport development in line with commercial logic. Independent initiatives pursued without consideration are likely to impact the viability of projects, which in turn could damage investor confidence and interest in the sector;

Non-Metro Airports Identified for Upgrade and Modernisation



Source: CAPA

- **Human Resources:** The critical role of skilled human resources in supporting the growth of the industry is often overlooked.

Investment in education and training infrastructure should be encouraged.

- **General Aviation:** This has been a neglected sector of the aviation industry but one which could have significant positive economic benefits. Development of general aviation requires a dedicated policy framework and infrastructure development. Current challenges include:

  - Absence of dedicated general aviation terminals, heliports and fixed based operations;
  - Restricted timings at key metro airports and lower priority clearance relative to commercial traffic;
  - Lack of hangar space and parking bays;
  - Limited maintenance facilities;
  - High import duties and a cumbersome import approval process;
  - Obtaining permission to operate at civil enclaves can be a lengthy process;
  - Severe shortage of skilled pilots and engineers.

- **Vision:** India lacks a long term vision for its aviation sector and requires a government with foresight to establish a 10-15 year master plan for the industry.

Conclusion

Indian aviation has made significant strides in the last five years. The challenges which it currently faces stem from a combination of the external market environment and the growing pains of what after all is a relatively young industry – the majority of airlines operating in India today did not even exist at the time of the last general election. The task for the new administration will be to create an environment which is efficient, transparent and viable for both operators and investors. It will not be an easy process, but the opportunity exists to create a world class industry that will play a critical role in driving India’s economic development.