

**4th Airneth Annual Conference**

**April 15, 2010 at The Hague**

**AIRLINES OF INDIA: ISSUES & CHALLENGES**

**Closing Speech by Saroj K. Datta**

Good evening Ladies and Gentlemen.

Let me begin by complimenting the organizers of this Conference. This has truly been an absolutely illuminating day for me.

May I also thank Prof Dr de Wit for inviting me to address this important Conference and giving me the opportunity to present my thoughts and views before the esteemed delegates attending the Conference today.

Closing speeches, as you will agree, are notoriously hard to make as, more often than not, all the really important issues have already been covered in the erudite presentations of the eminent speakers who have preceded and the delegates have also debated these various issues during the interactive sessions. And, of course, it is now the end of the day when everyone wants to go home (or to their hotel rooms).

Therefore, taking up from the theme of this Conference, I have selected Issues and Challenges being faced by the Airlines of India as the subject of my presentation. After all, that is the aspect of the aviation industry that I know most about. Let me hasten to add,

...2

however, that the views that I am going to express in my presentation are purely my own and not necessarily those of the organization that I work for.

Pulitzer Prize winner Daniel Yergin once called airlines "one of the great enablers of globalization; but, as an industry - a laggard in adapting to globalization owing to the peculiarities of its organization and the embedded weight of a half-century of national and international regulation."

I wonder what conclusion all of you have come to after today's deliberations.

Much has been said today about aviation scenario in the rapidly growing Chinese and the Indian markets. Nevertheless, I would like to take this opportunity to speak about the challenges that the Indian aviation industry faces in the next few years. My views have been formulated largely be from the point of view of a relatively new operator, and that too from one that is often referred to as a game changer in Indian aviation, an airline widely known Jet Airways!

Please excuse me if I seem to repeat some of the observations made by the earlier speakers, particularly Mr. Kapil Kaul, who has already given you an overview of the scenario and his, and CAPA's, Outlook for the next decade. Hopefully, however, I will be able to add some

comments and observations of interest to you from the point of view of someone grappling daily, if not hourly, with the issues and challenges. Hopefully, therefore, the views that I express will be different from those of a consultant who has the luxury of reviewing events and developments in hindsight—including having on view the mistakes that we practicing airline managers seem to be making regularly.

As you have been told, the Indian civil aviation industry entered a new phase after years of stagnation as a nationalized monopoly industry with Government ownership, control and management of the two national carriers—the only two operators-- when, in the early 1990's, the Government implemented the 'Open Skies Policy' for the domestic segment. Ever since then the industry has been on a roller coaster ride with the entry of several new optimistic investors and the equally quick disappearances of several of the newcomers.

This liberalization happened in two phases— first, in the early 1990s with the announcement of the new "Open Skies Policy" allowing the entry of private entrepreneurs and thereafter the dramatic reforms implemented during the 2003-2007 period.

However, the most important effect of the Government's new policies over the last two decades has been that Indian civil aviation industry has witnessed the emergence of true and effective competition in the domestic Indian segment providing choices to the traveling public,

with a conscious effort being made by the operators to recognize the importance of the customer and provide what he or she wants and not expect the customer to accept and live with whatever the airlines decided to offer.

And consequently, the industry now faces a much larger base of very vocal customers.

Apart from the entry of private entrepreneurs and of new privately owned operators, another important development that I would like to draw your attention to is that progressively, especially in the last couple of years, the Indian domestic market has rapidly adopted a no-frills low fare model. In my opinion, this development was speeded up by the economic and industry downturn of the last two years when the passengers had to make a choice between curtailing travel and living without the frills on relatively short flights-- the average sector length in India is less than one and half hours.

As pointed out in a recent CAPA Report, this low fare no frills operating model, which did not exist in a significant way in India even 4 or 5 years back, now accounts for almost 70% of the overall domestic capacity. And this has happened even though the country does not provide the essential basis—in terms of input costs and facilities—to sustain a LCC model.

Another aspect that I would like to draw your attention to is that even

though most of the airlines in India are recent entrants, except for the Government owned national carriers, they do not seem to have not been able to escape from and, also probably not bothered to learn from the experience of the industry of the developed countries – namely, the paradox that the aviation industry is characterized by high growth, though cyclical, and very low returns to paraphrase the comments of the famous Prof Rigas Douganis. Certainly, in the recent past they do not seem have followed the basic principles of economics; they have ordered a large number of aircraft and added capacity and basically attempted to play a market share game, that is work towards maximizing their market shares, without paying too much attention to the bottom lines. Either they have unlimited resources available or they have been expecting their competitors to fold up more rapidly.

In my opinion, the only good that has come of these developments has been a rapid expansion of the market base. The carriers have been attempting to entice a part at least of the huge traffic that travels by railways to air travel by offering fares competitive with the train fares, often ignoring though the differences in the cost structure.

What then are the primary issues that confront the Indian carriers.

As you know, the global industry losses in the aviation industry last year have been estimated at around US \$ 10.4 billion. However, the Indian aviation industry alone, which contributes no more than 2.5%

of the estimated 1.7 billion passengers who travel by air globally, is reported to have accounted for as much as 19% of the loss incurred globally.

One may rightly wonder: How could such a small portion of the global aviation industry incur such a huge financial loss?

There are three basic problems that confront the Indian aviation industry that are contributing heavily to its current unsustainable state.

First, is the high input costs; particularly the high fuel prices, result of the heavy taxes levied and the high user charges. The situation is getting worse not merely because of the periodic northward movement of crude oil prices and, therefore, of the Aviation Turbine Fuel prices but also the additional user charges that are progressively being introduced and levied by the new private airport owners. Add to that the high manpower costs airlines are forced to bear due to the severe shortage of trained and experienced personnel, especially Pilots and Engineers. For Jet Airways, for example, during the quarter October/December 2009, Aircraft Fuel Expenses constituted as much as 37% of the Total Operating Costs. The proportion will go up further this year since the Government has reintroduced a 5% customs duty on the import of crude oil.

I am sure you will agree that if the industry was to pass on all, or at least a large part of these additional costs to the traveling public, it can only adversely affect market growth and the expansion of the industry. But the dilemma for the airlines is how do they otherwise achieve viability

That brings me to the next problem area, Infrastructure. Lack of adequate infrastructure and navigational equipment constraints at Indian airports have a direct effect on the growth in traffic and the expansion of operations. While the Government of India has taken important steps to speedily improve facilities by privatizing several major airports, the solution often loops back to problem number one, resultant increases in input costs.

While the first two areas are substantial inhibitors in themselves, the most crucial problem faced by the industry is that of excess capacity that has been flooding the Indian market. Despite some cut-backs in capacity in 2008-09 due to the economic slowdown, I believe that there is still around 25% to 30% excess capacity in the Indian domestic market today, particularly if you take into account the substantial decline in yields that I have referred to earlier. And notwithstanding some carriers have already announced plans to add to their fleet induct additional capacity this year.

This serious mismatch between supply and demand has resulted in the

airlines adopting unhealthy market practices and offering fares that do not cover their costs.

Estimates show that the average prices are around 25%-30% below break-even levels.

Add to that is the fact that this unused capacity places additional pressure on the already limited infrastructure, because one still needs the same stretch of runway to take off and two pilots on the aircraft irrespective of the number of passengers on board. All this only makes the vicious circle of problems faced by the Indian aviation industry spin even faster.

In the light of what I've said so far let me turn now to the challenges that the Indian civil aviation industry faces going forward.

First and foremost I believe are the regulatory aspects. I am referring to the Indian Aircraft Act of 1934 and the Indian Aircraft Rules 1937. It is imperative that the regulations are modernized and brought up-to-date. It is true that several of the provisions framed during the infancy of the industry in India have been amended from time to time. However, in my opinion it is necessary that a more holistic view be taken of the applicable laws and the rules and regulations to produce a modern comprehensive framework. It is a challenge that the airlines



have to tackle, to lobby with and persuade the Government to achieve this on a priority basis and thereafter to follow-up with an appropriate regulatory organization and structure. Of particular importance to my mind is the requirement to separate regulation of the industry and investigations into incidents and accidents.

Secondly, to be able to sustain future growth and expansion, there is an acute requirement for rapid investments in and an expansion of the supporting infrastructure facilities. A start has been made by the Government with the privatization of the 4 Metro airports, namely Mumbai, Delhi, Bangalore and Hyderabad and the commencement of the up-gradation and modernization of 35 other airports including the two other metros, Chennai (formerly known as Madras) and Kolkata (formerly known as Calcutta). The current situation of flights holding overhead Mumbai and Delhi, for example, and sometimes even diverting because of congestion and as a result burning additional fuel and incurring substantial additional costs cannot be sustained for very long by an industry already faced with high input costs.

Thirdly, as I have said earlier, the last 3/4 years have witnessed the transformation of the Indian aviation industry with the LCC model becoming its dominant feature, even though some of the essential elements that contribute to the LCCs achieving lower unit costs do not exist in the Indian environment. As you know, all the 3 full service model carriers in India, namely Air India, Jet Airways and Kingfisher have created their own LCC arms—Air India Express, Jet Airways

Konnect and Jet Lite and Kingfisher Red respectively to sustain/boost their market shares and improve their per flight revenues. I expect, however, that as the Indian air travel market progressively expands and air travel penetrates a larger segment of the population, and entices people with rising aspirations and increasing disposable incomes who have hitherto been using other forms of transportation, the basic character of the LCC model in India will also change. I believe that what Mr. Patrick Murphy, the former Chairman of Ryanair has recently described as the "Hybridization" of the LCC model is round the corner and will occur more rapidly in the Indian scenario. I can see signs of it already in the Indian market.

For the Indian carriers the challenge that this development creates is far greater I believe than for carriers in the developed world because of the high input costs that we have to contend with. How to realign their input costs with this model and yet have an operation with a healthy bottom line generating adequate resources to achieve self-sustaining growth, is a mighty challenge that each of the operators and the industry will have to tackle going forward. As I have mentioned earlier, apart from the high taxes that are levied by the Central and State Governments on Aviation Turbine Fuel for domestic uplifts, the high user charges payable at Indian airports make the problems even more difficult for the operators. In fact the modernization of the airports, whilst improving facilities, has led to a spurt of additional levies and increases in user charges by the new operators which the airlines have no option but to pass on to the passengers. These charges are ostensibly being put in place because

the new owners/operators say that this is the only way they can hope to get a return on their investments. The negative impact of such increased levies on traffic growth is an issue that the airlines will need to contend with going forward.

The airlines and the Government will have to decide whether going forward whether with the change in the composition of the traffic, India needs to build airports as showpieces or those which provide basic facilities at minimal costs.

Another major challenge that the airlines face is how to raise adequate financial resources to provide for future growth and expansion. The airlines in India are presently very highly leveraged—figures available show that the 3 full service carriers combined have a debt burden of over USD 10,000 million! It is admittedly going to be an uphill struggle.

How to achieve and sustain viability will therefore continue to be of crucial importance to not merely each carrier but to the industry as a whole.

The civil aviation industry, from my experience, appears to be the only one of which does not fix tariffs on a cost plus basis—an effect, I guess of liberalization and the resultant over capacity situation—a situation created by the airlines themselves. And the Indian airlines of course

have made their life more difficult by putting in place a fares regime that does not cover costs and playing the market share game.

In fact the industry and the policy makers additionally face the dilemma of how to deal with the requirement of generating funds to make substantial additional investments in modernization and expansion of airport facilities so as to cater to the growth of the market and increased level of operations and still be able to offer user charges consistent with the cost structures of the low fare carriers and in fact create conditions that are conducive to successful LCC operations.

These are only a few of the major dilemmas that the Indian civil aviation sector faces going forward. While the situation does seem grim, let me hasten to assure you that I am nevertheless optimistic about the future of the Indian aviation industry. The reasons are manifold; but the principal ones are the extremely low penetration of the market in terms of air travel and the rapid expansion of the economy and the resultant rising aspirations of the huge expanding middle class.

The link between the growth of an economy and its civil aviation industry is a given. If India's economic progress is to proceed on a firm footing, its civil aviation industry and the support infrastructure must continue to grow, expand and get stronger in tandem. It is to put it simply, indispensable. In fact it has been universally acknowledged

-13-

that the aviation industry is a crucial and essential support for sustained economic growth, particularly for a country with a huge land mass such as India and also an important generator of employment and of support industries, including tourism and the hotel industry.

Finally, it is worth remembering that given the physical reach and spread of India as well as the size of its population, the present air travel market has to expand many times before it reaches saturation point Hence the future growth potential is still immense.

Ladies and Gentlemen, I apologise if I have taken too much of your time to convey my views and perspective. Let me, therefore, conclude by leaving you with my personal belief - Turbulence is part of the aviation industry, but then so is its ability to soar toward the sky! The challenge lies in keeping a close watch on the financial health of the industry and to frame policies conducive to the sustainability of the sector. And for the players and the operators to pay greater attention to basic economic principles.

Thank you for listening to me so patiently.