S k y T E C H A R T I C L E

Can Indian carriers soar in the open skies?

India, one of Asia's largest economies, has a small international air travel market of 15 million passengers (2003-04), which has grown at a CAGR of 14% in the last two years. The Centre for Asia Pacific Aviation (CAPA), a leading aviation consultancy firm based in Sydney, estimates that India's overall air traffic will rise by 5 million passengers each year over the next ten years - translating into a CAGR of 11% over the next decade.

The Indian Government has recently signed a few bilateral agreements that allow new carriers and increased flight frequencies into India. These include agreements with China, UK, US and Qatar, all of them having provision to increase flight frequencies. The agreement with China allows designated airlines of both countries to operate 42 flights by next summer. The deal between UK and India *doubles* the number of weekly flights between the two countries by November next year. The agreement with US removes restrictions from air carriers of both nations in establishing routes *between and within* the two countries, *removes regulations on pricing and* allows airlines from both countries to form *cooperative alliances* in transporting passengers. There are a few more proposals with Germany, Belgium and the European Union. As a result, many foreign airlines have recently announced their plans of operating flights to India. Similar agreements such as open sky pacts that India made with Sri Lanka and ASEAN in the last couple of years led to significant growth in air traffic.

These agreements result in reduction of prices, improved customer service and better connectivity. However, industry experts feel that in such an open market scenario, Indian firms will face stiff competition from foreign airlines. To begin with, the Indian aviation industry is facing a shortage of trained pilots. Kapil Kaul of CAPA estimates that Indian carriers will require around 3,000 pilots during the next five years - more than the total number of pilots hired over the past half century! Most airlines, including Air India, are considering hiring foreign pilots. The Union Civil Aviation Ministry is also considering a proposal to reduce the flying time (currently 250 hours) required for issuing license to pilots.

Of the 100 countries with which India has Air Services Agreements, Indian carriers connect to only 25 nations. "While foreign airlines have used 80-90% of the bilateral seats, our utilization has been as low as 40–50% because we don't have the aircraft to fly," says an airline insider. As of now, Air India is the only airline that has ‘expanded international operations’, the other two, Jet and Sahara, being new entrants in the international market. It is going to be a ‘do or die’ situation for all these airlines with almost all the majors in the industry expanding their services here.

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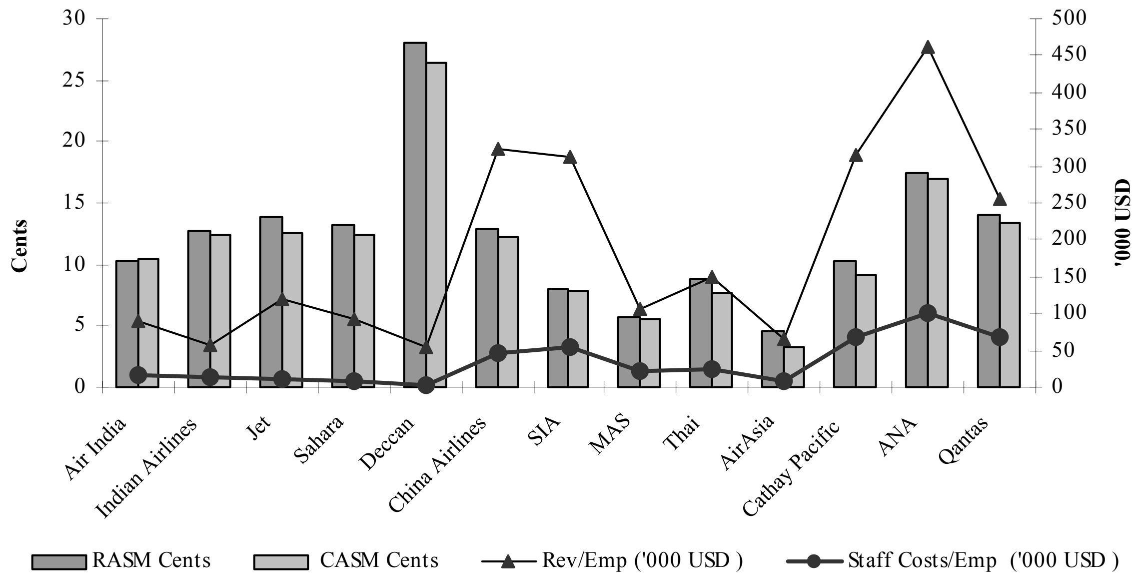

Illustration 1: Source: DGCA & Annual Reports (2003-04)

The CASMs (Cost per Available Seat Mile) of Indian carriers are higher than those of major international carriers, the reason being their small operational base, short stage lengths and soaring fuel charges. Their high RASMs (Revenue per Available Seat Mile) indicate their ability to charge more. However, the low costs per employee in India would definitely help the Indian carriers when they go international. This advantage should compensate the soaring fuel costs to a great extent, even though not as a whole.

In response to the changing scenario, the Indian firms have recently placed huge orders for over 200 new aircraft. They will have to improve their service to match international standards. Also, foreign carriers operating in India with large operating margins can reduce their fares, further intensifying the competition.

Most Asia Pacific carriers have spent less than 10 US cents per Available Seat Mile (ASM)(Illustration 1). Malaysia Airlines, Singapore Airlines and Thai Airlines, in spite of their size and stretch, have costs well below 8 US Cents per ASM.

Almost all the above Asia-Pacific carriers have operations in India. In this scenario, an 'open skies policy' between India and any of the Asia Pacific nation or groups like ASEAN will make things difficult for the Indian carriers. The Indian IT industry is keen to see EU-style Open Skies in SE Asia, which would act as a catalyst to open the whole region for businesses. For this to happen, the Indian carriers must match the sleek operations of carriers like Malaysia and Singapore Airlines. Rono Dutta of Air Sahara says, "Around 35-40% of our costs at present are government imposed. Internationally, this figure is around 15-20%". For example, aviation turbine fuel (ATF) prices in India are subject to 8% excise duty and a sales tax averaging above 25%, levied by state governments. So, airlines in India have to spend 30-35% of their operating costs on ATF, while other Asia Pacific carriers spend around 20%, American carriers spend about 17% and European carriers spend less than 15% of their costs on fuel. An advantage for foreign carriers, operating to India, is that ATF sold to them in India is *exempted* from sales tax.

It is a good sign that despite the much higher costs per seat mile (CASM), the Indian carriers still managed good operating margins. But, one should not forget that India has an advantage of lower staff costs (Illustration 1).

Many carriers in Asia Pacific spend about 20% (and some, even more) towards their staff costs, while Air India and China Airlines spend just 15%. Jet and Sahara spent 9% of operating expenses on staff (2003-04). If they continue to operate at 9%, they would be more competitive and can tackle price cuts by foreign carriers. While comparing airline operations, it is important to consider average stage lengths in conjunction with CASM. In the comparative chart, Air Deccan's statistics stand out. Its unit costs as well as unit revenues are more than twice that of the other Indian carriers, which would seem implausible, especially when it is categorized as an LCC. But, Air Deccan for the most part, operated short-haul routes, which might explain to some extent the higher CASM, and its ability to charge more revenue per passenger mile at full load factors - to have a matching RASM. International flights mean longer flights, reduced number of landings and take-offs, and a larger fraction of block hours spent airborne, resulting in lower unit costs. (CASM of *domestic operations* of Jet and Sahara are shown in Illustration 1). This should decrease when they operate on international routes. Illustration 2 shows the trend lines of the operating margin with the CASM, in different regions.

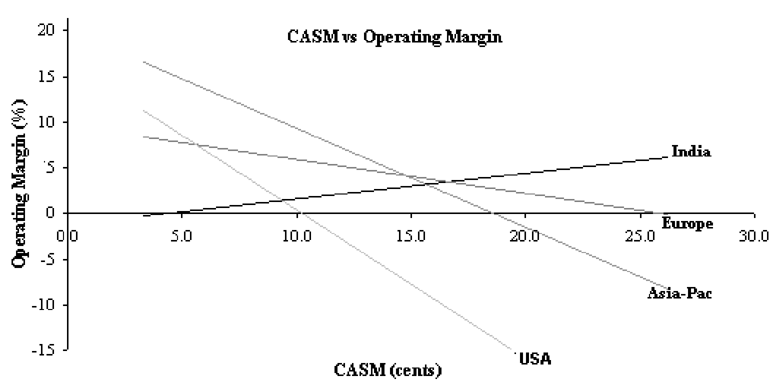

Illustration 2

In international market, the usual trend is that the Operating Margin of an airline increases with a decrease in its CASM. The case in India, however, had been different because the carriers were mainly domestic. But now, the carriers have become international which should bring their CASMs down.

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Consider Jet Airways, which had an average stage length of 816 kilometers (507 miles) for 2003-04, and CASM of 12.5 cents. Assuming one-third of its operations are international (2000 Mile-stage length) and the other domestic (500 Mile-stage length), the average stage length would become 1000 miles. Thus, as per the standard cost curve, the CASM would come down to 8.8 Cents. This would be at par with, in fact better than, many Asia Pacific carriers, which are already operating similar or longer average stage lengths.

In response to the changing market dynamics, Indian firms should consider joining airline consortiums. Through extensive code-share agreements, member airlines can serve their global passengers with more destinations than they could do individually. There are also benefits like streamlined airport operations, cargo co-operation, joint purchasing of resources, advertising and promotions. **Air Sahara** is strengthening its relations with American Airlines, Cathay Pacific and British Airways, all of whom are members of One World Alliance. Alternately, **Jet**'s highly successful IPO is a sure sign of the faith investors have in its future. And the bet seems well placed, as of now.

References: Various sources in the public domain

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