Chapter 4 Merger of AIL and IAL into NACIL

4.1 Initiation of Merger – March 2006

The initial reference to the merger of AIL and IAL in the records of MoCA is a noting of 16 March 2006 that the Minister, Civil Aviation had desired a concept paper on the integration/ merger of AIL and IAL; AIL had sent a concept paper prepared by the consultants, AT Kearney. As mentioned elsewhere, this concept paper of 2004 (which highlighted the potential for value creation through collaboration on fleet and network between IAL and AIL) was referred to in the December 2004 note on liberalisation of bilateral agreements, but was re-considered only after completion of independent fleet acquisitions by both airlines.

Subsequently, a presentation was made on 22 March 2006 before the Prime Minister on the issue of the proposed merger of AIL and IAL[27]; a copy of this presentation could not be retrieved from MoCA's records. As per the file notings:

- In the presentation, it was highlighted that in the light of the global trend towards consolidation in the airlines industry, it had become incumbent for the two national carriers to work towards merger, as the merged entity would not only be able to compete effectively in the market but would also find greater acceptability amongst the global alliances. It was emphasised that given the overall developments in the civil aviation sector internationally as well as in the domestic sector, nothing short of merger would be an effective way to compete effectively in the market.
- During the discussions held after the presentation, apprehensions were expressed with regard to the HR problems arising due to merger. However, it was felt that it would be in the overall interest of both AIL and IAL to sort out these issues and work towards merger under the guidance of MoCA.
- During the discussions, it was, inter alia, suggested that the MoCA may examine the possibility of certain interim measures like formation of a holding company of both AIL and IAL preceding their full merger.
- ***After detailed deliberations, 'in principle' approval was given for working towards the merger of AIL and IAL and to bring up a Cabinet note with full details at a later date in this regard.***

In view of the 'in principle' approval for working towards merger of AIL and IAL, the following course of action was approved:

- Since AIL had taken the lead in making the presentation, they would be asked to engage a consultant, in consultation with IAL, to advise on the merger process, for which a draft Terms of Reference (ToR) was also prepared;

[27] Others present were the Minister, Civil Aviation, Dy. Chairman, Planning Commission, Pr. Secy to PM, Secretary, MoCA, CMDs of AIL and IAL, JS to PM, and JS, MoCA

- Working Groups for Commercial, Finance/ Accounts, Engineering/ Operations and HR involving officials of both AIL and IAL would be constituted.

These decisions were conveyed by MoCA to the erstwhile AIL on 20 April 2006.

Based on available records, we are unable to ascertain the detailed justification for, or the background to the 'in principle' approval of GoI for 'working towards the merger' of AIL and IAL. However, in our opinion, the initiation of action towards the merger in March 2006, less than a few months after completion of independent large scale acquisition of aircrafts by IAL (Airbus) and AIL (Boeing) in late 2005 (after long drawn out procedures/ negotiations) appears somewhat ill-timed, with loss of significant synergistic opportunities.

Had the possibility of merger (with attendant route rationalization, network integration, common maintenance/ overhauling facilities and other synergies) been considered – even at a late stage – in the process of fleet acquisition, the underlying economics (including frequencies, routes, seating, and other operational aspects) could have been significantly altered; perhaps, even a common acquisition process for AIL/ IAL could well have been considered. In our view, the potential benefits for the merger would have been far higher, had this been undertaken before finalization of the massive and separate fleet acquisition exercises undertaken by AIL and IAL.

The subsequent chronology of events relating to the merger is summarised below:

Table 4.1 - Chronology of events relating to the merger of AIL and IAL

Timeline	Event(s)
July 2006	Joint Committee of Boards of AIL and IAL on Merger (constituted by GoI) selected Accenture India Pvt. Ltd. as consultant to advise on the merger.
October 2006	Cabinet Secretariat communicated the constitution of a GoM[28] to consider the suggested roadmap for the merger proposed by MoCA, financial and legal issues etc.
November 2006	GoM raised concerns on the merger proposal and desired that a CoS (chaired by Cabinet Secretary) examine the following issues: • While merger of the two airlines was a deliberate goal, the process should be so tailored that the benefits of synergy were not dissipated by addition of inefficiencies, especially on the manpower side.

[28] chaired by the then Defence Minister, Shri Pranab Mukherjee

Timeline	Event(s)
	• There was a declining trend in the financial and operational performance of the two airlines. The merger process would be successful only if these concerns were suitably addressed. • The two airlines were presently overstaffed. There were some differences in their work culture as well.
December 2006	CoS agreed with the merger proposal, and decided that: • GoI would provide the necessary relaxation from the existing norms/ rules on need basis for effecting the merger quickly. • A team in MOCA may be constituted under the Secretary, to guide, co-ordinate and facilitate the merger process.
January 2007	Pursuant to directions of GoM, MoCA held meetings with employee associations of AIL and IAL.
February 2007	GoM decided to recommend to the Cabinet that the proposal for merger of AIL and IAL be approved.
1 March 2007	Cabinet approved the proposal for merger.
30 March 2007	National Aviation Company of India Ltd. (NACIL) was incorporated.
22 August 2007	AIL and IAL stood dissolved and merged into NACIL; the approved scheme of amalgamation set the "appointed date of merger" as 1 April 2007.

The Ministry in its reply (August 2011) elaborated the background and rationale for the merger and acquisition of aircraft, and stated that the merger would not have altered the aircraft acquisition programme significantly, and that no losses could be attributable to the merger.

We do not agree. In our opinion, merger before aircraft acquisition could have the potential for altering the acquisition strategy. Further, we did not comment about the merger causing losses, but had merely highlighted the failure to implement the merger as envisaged, as it was ill timed with loss of significant synergistic opportunities.

4.2 Objectives and Envisaged Benefits of Merger

According to the consultant (Accenture), the merger was intended to:

- Provide an integrated international/ domestic footprint, which would significantly enhance customer proposition and allow easy entry into one of the three global airline alliances;

- Enable optimal utilization of existing resources through improvement in load factors and yields on commonly serviced routes, as well as deploy 'freed up' aircraft capacity on alternate routes;
- Provide an opportunity to fully leverage strong assets, capabilities and infrastructure:
  - ❖ Parking bays and landing slots in an 'infrastructure constrained' environment;
  - ❖ Potential to launch high growth & profitability businesses {Ground Handling Services (GHS); Maintenance, Repair & Overhaul (MRO) etc.};
  - ❖ Potentially enable the merged entity to command better valuation;
- Operate a combined fleet strength (~112), which would be the largest in India and comparable to other airlines in Asia/Region {Emirates (93), Singapore (118), Malaysian (110);
- Provide maximum flexibility to achieve financial and capital restructuring through revaluation of assets and cleaning up of financial books;

Besides the above, a merged airline would be in a better position to serve and promote the airport hubs now being developed at the metro cities, pursuant to the airport restructuring and modernization programme approved by the GoI, by providing seamless connectivity over domestic and international networks.

According to the consultant, the following benefits were envisaged:

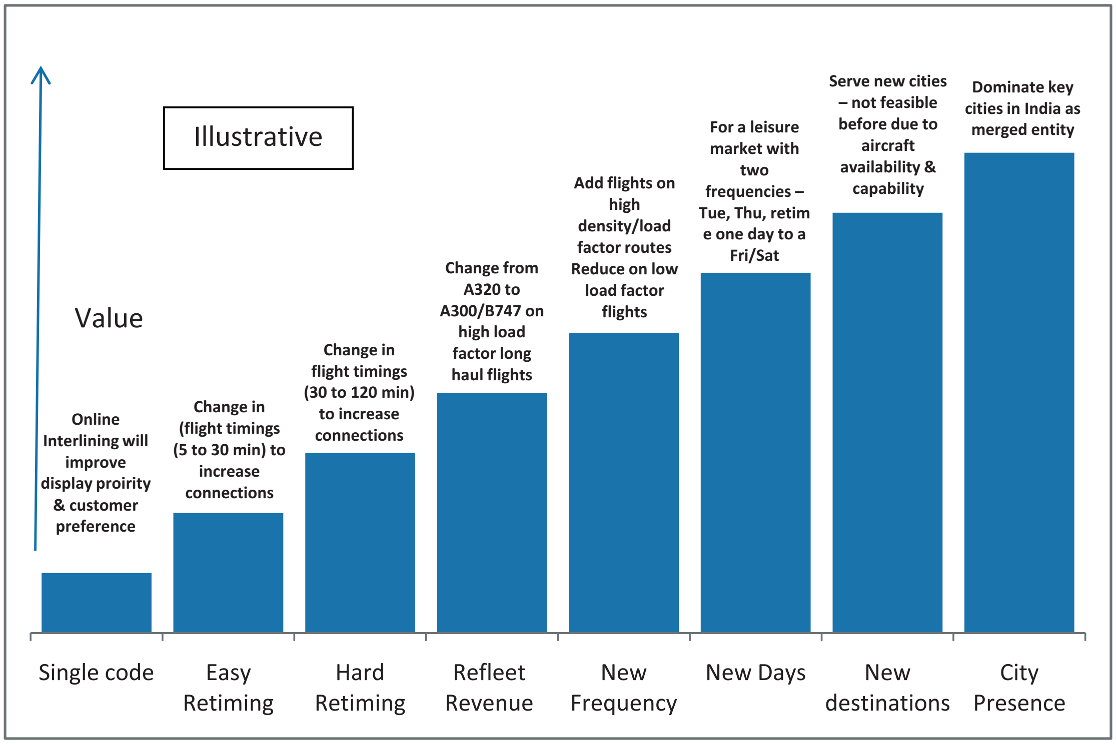
- Net synergy benefits of Rs. 820 crore (against the integration cost of Rs. 200 crore) was envisaged; potential recurring synergies were expected to enhance profitability by Rs. 600 crore at the end of the 3rd year of merger.
- The merger would make the combined airline the largest in the country, improve combined market share, result in a combined balance sheet (which would be important for an IPO), and revaluation of assets of both airlines (which would be possible only after a merger) and improve net worth.

4.3 Lack of adequate validation of financial case for merger

In our view, the main focus of the process leading upto the implementation of the merger was on consideration of alternative options for merger, stamp duty and tax implications, creation of top level posts for accommodating existing incumbents etc. However, the financial case for merger was not adequately validated, prior to the merger.

- In the consultant's report, the synergies likely to be yielded by progressive integration of networks and operations had been illustrated as follows:

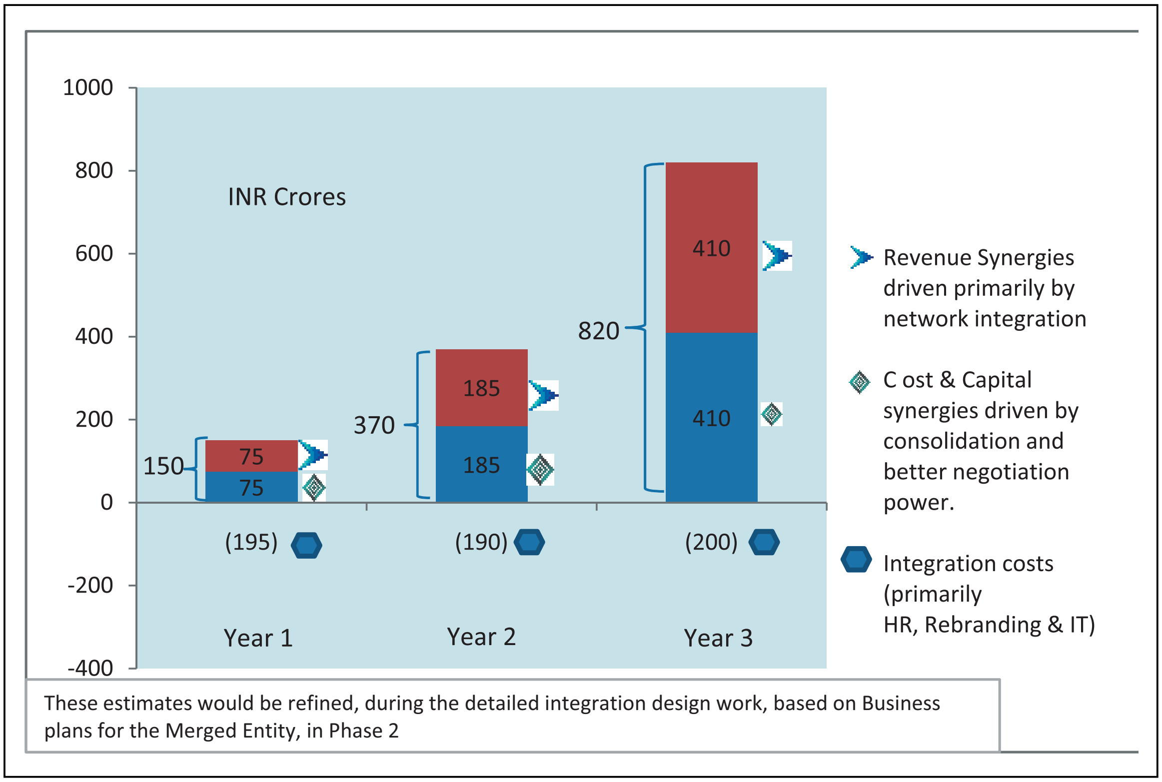
Chart 4.1 – Progressive integration of networks and operations is expected to yield significant synergies



However, the details of how these were likely to, or should, work out in practice had not been explored in depth.

- The Accenture report expected synergies on two counts – revenue synergies (primarily on account of network integration) and cost and capital productivity synergies (leveraging economies of scale for rates for catering, crew boarding and lodging etc.; opportunities for rationalizing overlapping facilities and infrastructure e.g. international locations serviced by both airlines). A figure of Rs. 820 crore on account of synergies at the end of the third year after merger was projected by the consultant.

Chart 4.2 - Expected build-up of synergy benefits and integration costs



- However, except for a statement that profitability would be enhanced by over Rs. 600 crore (4 per cent of current combined revenue), detailed item-wise financial analysis was not available, so as to assess the reasonableness and robustness of these projected savings.

- The only major accounting implication highlighted was that the post-merger net worth would go up considerably (from Rs. 185 crore as of 2005-06 to Rs. 2557 crore), mainly due to revaluation of fixed assets by 50 per cent of the current book value. Obviously, this had no operational or cash flow benefits.

- One of the key assumptions for improved employee productivity was that the merged entity would have fewer employees/ aircraft on account of increase of fleet through procurement, and reduction of employee base by around 4,000 due to expected retirements. However, such expected improvement in employee productivity had not been achieved, and was, in any, case not directly dependent on the merger.

The Ministry in its reply (August 2011) narrated the action taken during the last four years, like route rationalization, combined insurance policy, etc. and the benefits accrued in the first year of merger and also stated that the consultant had looked into the financial aspects of the merger.

The reply is not tenable as our finding relates to the inadequate validation of the financial case for merger, prior to the merger.

4.4 Huge Delays in Actualisation of Merger/ Integration

Although the merger of AIL and IAL was officially notified in 2007, the integration process had still not been fully completed, as described below:

4.4.1 Delays in implementing Single Code Passenger Reservation System

A critical element in the integration of the networks of the erstwhile AIL and IAL was the integration of the reservation systems to help the merged entity (AIL) to operate all its flights on a single code, and reap the benefits of network integration through seamless travel for passengers on all domestic and international routes.

Prior to the merger, the two airlines were using separate reservation systems (UNYSIS system by AIL and IBM system by IAL) with separate airline codes (IC for Indian Airlines flights and AI for Air India flights). The then Minister, Civil Aviation had stated in Parliament on 2 March 2007 that the merged airline with one code was expected to be in place within 16 weeks. Further, the action plan for the merger indicated a timeline of August 2008 for integration of the reservation systems.

However, there were enormous delays in implementing the single code passenger reservation system[29]. The contract for the upgradation of the existing Passenger Service Systems (PSSs) of the two airlines into a single code reservation system was awarded only in April 2010, and the single code reservation system was activated only in February 2011.

Further, the integration of domestic flights into the PROS revenue management software, which was critical for efficient yield management, had still not taken place; this is described further in this report.

The Ministry in its reply (August 2011) stated that due to the complexities involved, the integration process was taken up in a phased manner and that the compliance of PSS related components is a time consuming process and the PSS had been put in place effective February 2011. Further, during the exit conference, the Ministry indicated that though the merger was to have been completed within 36 months, normally it takes 4-5 years period, which is the normal period by which such mergers are completed.

The reply is not tenable as the merger process was delayed and is yet to be completed even after 4 years. Further, the Ministry and AI should have framed realistic timeframes for merger, duly considering the experiences of mergers in the airline industry.

4.4.2 Membership of "Star Alliance"

In a dynamic and growing passenger air transportation industry, the pooling of the resources of multiple carriers in the form of airline alliances is considered to be of critical importance for several reasons:

[29] One reason for the delay was a vigilance complaint filed by an unsuccessful bidder, which resulted in detailed examination of the case by the Central Vigilance Commission (CVC).

- It helps to bring together networks, lounge access, check-in-services, ticketing, 'move under one roof' projects and a host of other services to improve the travel experience for the customer and efficiencies for the airlines.
- It also reduces the costs of individual airlines from economies of scale.

Consequently, one of the targeted objectives of the merger included easy entry into one of the three global airline alliances.

After paying an entry fee advance of € 5 million in June 2008, NACIL's entry into the Star Alliance was intended to take place in March 2009. The balance of € 5 million was required to be paid at the time of entry into the alliance. Out of the pre-requisites for joining the alliance (Minimum Joining Requirements – MJR), the most important requirement was a passenger reservation system with a single code for both the erstwhile airlines, which did not take place until February 2011. Since Star GmbH was not ready to extend the timeline for payment of balance 50 *per cent* joining fees beyond 30 June 2010, AIL paid the balance entry fee of € 5 million in 12 equal instalments from January 2010 to December 2010.

The Ministry stated (August 2011) the delay in joining Star Alliance was on account of large number of Minimum Joining Requirements (MJR) and the time consuming process involved, and this was likely to be fulfilled by 31 July 2011. In response to our requests for clarification during the Exit conference (August 2011) as to the latest status of Air India joining Star Alliance, the Ministry informed that Air India had met 90 per cent of the requirements of the MJRs. Thus, as far as the Government was concerned, Air India was all set to join the Star Alliance. The Ministry also clarified that they had received no formal communication about Air India having been denied entry into the Star Alliance and had, in fact, also learnt about this from the news reports in the press. The Ministry also stated that the decision of Star alliance to exclude AI would not have any major impact on AI's operations.

We do not agree. Setting aside the Ministry's obfuscation regarding the status of joining the Star Alliance, we believe that AI's not joining the Alliance in the near future could significantly affect its financial and operating performance on international sectors.

Even four years after the merger, AI is yet to join the Star Alliance, mainly due to the delay in setting up a single code passenger reservation system. In fact, as per the press release of 31 July 2011 available on the Star Alliance website, AI's application for membership of the Star Alliance has been "put on hold", and the integration of Air India into the global airline alliance "will be suspended". This raises the likelihood of indefinite delays as also serious uncertainties on AI's prospects for joining the alliance.

4.4.3 Harmonization of Human Resources (HR)

Even at the time of the 'in principle' approval (March 2006) on working towards the merger, apprehensions with regard to HR problems due to the merger were expressed. These issues remain a critical impediment to the merger, and have still not been fully resolved.

In January 2007, as directed by the GoM, MoCA held meetings (before the decision to merge) with the employee associations/ unions of the two airlines, where three key issues were highlighted:

- Pendency of wage revision of employees with effect from January 1997 in terms of DPE guidelines;
- Employees who joined the two airlines around the same time being in different positions/ grades, due to differences in promotion policy; and
- Spelling out the viability of Memorandum of Settlements, Agreements and Awards[30] pursuant to the merger.

While making assumptions on the merger process, the consultant (Accenture) clearly indicated that it would not provide advice, options or any other deliverables around areas concerning manpower rationalization, compensation, or restructuring of workforce. Consequently, HR integration was taken up internally, and an integration cell was set up only in September 2007.

HR integration below the level of DGM, representing 98 per cent of the staff, has still not taken place. Pay and allowances, seniority, promotions and transfers etc. had still not been harmonised. Consequently, Industrial Relations (IR) disputes have arisen. The key issue with regard to HR is not one of job security or protection of compensation/ perquisites, but one of perceived disparities between employees of the erstwhile separate airlines.

As an in-house exercise, incorporation of HR issues like service regulation, annual performance appraisal, recruitment and promotion is still ongoing, as also issues of seniority, compensation, union recognition etc are continuing. This is stated to be due to the financial condition of AI, since HR integration involves pay parity and thus substantial financial outgo.

In February 2011, during a meeting held by MoCA with the unions, there was a consensus on the appointment of an independent committee of experts from outside the organization who would impartially examine all the issues relating to service conditions, wage and allowances paid in the erstwhile entities, together with the requirement to harmonize/rationalize the same. It was envisaged that it would be linked to the best market practices, competition culture and performance parameters. This Committee has been constituted in May 2011 under the chairmanship of Justice Dharmadhikari.

The Ministry accepted (August 2011) the delay in HR integration and, during the exit conference indicated the steps being taken to integrate manpower. The fact remains that the delay in HR integration has significantly affected the completion of the merger.

[30] Both airlines had an age old system

4.4.4 Route Rationalisation and Network Integration

Consequent to the merger of erstwhile AIL and IAL, AI undertook re-structuring of operations between the networks of the erstwhile entities as under:

- Route rationalization by identifying overlapping operations between the erstwhile airlines in Middle East and East Asia was done in phases by end 2008;
- 'Through flight numbers' , which would improve AI displays on Global Distribution System (GDS) and thereby enhance sales, were given on a few routes[31];
- Network integration by matching the route potential and market requirements was done;
- Overlapping operations between erstwhile IA coded flights and subsidiary, AICL (IX coded) flights were removed/ minimized;
- A Strategic Group was formed (August 2008) by AI Board to consider various measures including analysing all routes, withdrawal / curtailment of services on routes not meeting cash costs, implementing cost reduction and revenue enhancement strategies in the short/ medium/ long term and evolving suitable turnaround strategy. During 2008-09 and 2009-10, loss making international and domestic services[32] were withdrawn, routes were restructured[33] to reduce costs/ losses, new routes/ capacity increase on international/domestic services[34] were implemented, hub at Frankfurt operationalised (due to absence of infrastructure for hub operations in India) for services between India and USA, and unproductive positioning legs on international services eliminated.
- Further, the launch of T-3 (Terminal -3) at New Delhi enabled AI to designate Delhi as the hub for integration of international and domestic operations and for providing convenient connections between international and domestic destinations with reduced connecting times.

We acknowledge the substantial efforts made by AIL towards route rationalization/ network integration. However, given its present critical financial position, AI needs to further endeavour to reap the synergy benefits in network integration.

The Ministry's reply (August 2011) cited the efforts taken for route rationalization, which have already been acknowledged in the report.

4.4.5 Finance

Even after four years of merger, the erstwhile AIL and IAL (now termed internally as NACIL – wide body and NACIL – narrow body) have separate accounting package. A common

[31] Hyderabad-Mumbai-New York, Kolkata-Delhi-New York, etc.

[32] Delhi-Frankfurt-Los Angeles, Ahmedabad/ Kolkata-London, Mumbai-Nairobi, Mumbai-Bangalore-Dubai, Mumbai- Bangalore, Chennai-Mumbai, Mumbai-Baroda, Kolkata-Ahmedabad/Jaipur, etc.

[33] Chennai-Trichy-Calicut-Kuwait, Chennai-Kochi-Goa-Kuwait, Mumbai-Delhi-Lucknow, Mumbai-Kochi-Trivandrum etc.

[34] Bangalore-Male, Delhi-Kathmandu, Mumbai-Rajkot, Kolkata-Delhi, etc.

integrated ERP has still not been implemented, as AI kicked off the project work only in January 2011.

The Ministry replied (August 2011) that it took extra time due to the vast extent of accounts activities, and the new timeline for completion of ERP had been fixed as 31 March 2013. In our opinion, the timeline for implementation of ERP would be challenging, as the project work commenced only in January 2011

4.4.6 Synergy benefits not quantifiable

The original estimates of synergy benefit (Rs. 820 crore) were refined during the detailed design work by the consultant (Accenture), and the annualised estimates of revised synergy benefits projected were Rs. 996 crore. As against this, the actual accruals were to the tune of Rs. 503 crore till December 2008 (as claimed by Accenture in a presentation made in April 2009). Subsequently, the Management stated (March 2010) that the quantification of subsequent synergy benefits was practically difficult on stand alone basis because the benefits of network integration were the cumulative effect of many factors.

The Ministry reiterated (August 2011) the AIL Management's earlier reply (March 2010) in this regard.

4.5 MoCA's response

In February 2011, the Ministry stated that the merger process was examined in all aspects at various levels - by the Consultant (Accenture), the Ministry, the Minister, a Committee of Secretaries, a Group of Ministers (GOM) and the Cabinet of Ministers. This was, thus, a collective decision arrived at after multiple levels of due diligence. MoCA claimed that integration had been completed in many areas like organisational structure and was under progress in many other areas like sales and marketing, IT, passenger service system, enterprise resource planning, property *etc.* However, the Ministry admitted that integration of HR policies had a financial outgo; the delay in harmonising was also due to critical financial condition being faced by AI and pay, allowances and career progression were governed by the agreements/settlements with various unions/associations of the two erstwhile companies.

The Ministry reiterated (August 2011) its earlier reply of February 2011 relating to merger and cited the progress made in HR integration, constraints in execution, etc. In our opinion, these difficulties, including the critical aspect on HR integration, should have been foreseen and planned in detail before the merger.

While we take note of the efforts being made by MoCA and AI for completion of the merger process, the process is still incomplete, despite lapse of four years from the merger (2007). In our opinion, this is largely due to lack of adequate validation of the financial implications of the merger, as well as inadequate appreciation of the difficulties in harmonizing human resources of the two airlines. Further, one of the biggest potential benefit of merger – viz. fleet integration – was not available, since the two airlines had just concluded huge and long drawn out fleet acquisition exercises independently.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