Chapter 6 Financial and Operational Performance

6.1 Operational performance

6.1.1 Key Operational/ Revenue Parameters

A summary of key operational/ revenue parameters for the two airlines (pre/ post-merger) is presented below:

Table 6.1 – Key Operational/ Revenue parameters during 2005-10

	2005-06	2006-07	2007-08	2008-09	2009-10
Passenger Revenues (Rs. crore)	10397	10242	9954	9267	9150
Cargo Revenues (Rs. crore)	818	748	673	662	691
ASKM[48] (million)	47274	47969	48393	43591	44723
ATKM[49] (million)	5786	5840	6168	5602	6053
RPKM[50] (million)	31403	31483	30890	25950	28965
RTKM[51] (million)	3505	3456	3689	3191	3533
Passenger revenue/ RPKM (Rs.)	3.31	3.25	3.22	3.57	3.16

Note: For 2005-06 to 2006-07, figures in respect of IAL and AIL have been summed up, while figures for 2007-08 to 2009-10 are in respect of the merged entity (AI).

A break-up in respect of IAL / NACIL (narrow-body) and AIL / NACIL (wide-body) reveals the following position:

Table 6.2 – Key Operational/ Revenue parameters in respect of IAL/ NACIL (narrow-body) and AIL/ NACIL (wide-body)

	IAL/ NACIL (narrow-body)		AIL/ NACIL (wide-body)	
	2005-06	2009-10	2005-06	2009-10
Passenger Revenue (Rs. crore)	4709	4496	5688	4654
ASKM (million)	16308	15846	30966	28877
RPKM (million)	10891	10855	20511	18110

[48] Available Seat Kilometers
[49] Available Tonne Kilometers
[50] Revenue Passenger Kilometers
[51] Revenue Tonne Kilometers

	IAL/ NACIL (narrow-body)		AIL/ NACIL (wide-body)	
	2005-06	2009-10	2005-06	2009-10
Passenger Revenue/ RPKM (Rs.)	4.32	4.14	2.77	2.57
Passenger Load Factor (%)	66.8	68.5	66.20	62.77
Cargo Revenue (Rs. crore)	242	198	576	493
ATKM (million)	1593	1637	4193	4417
RTKM	1141	1089	2364	2444
Overall Load Factor (%)	71.6	66.5	56.40	55.30

There was a significant deterioration in operational performance on most parameters (passenger/ cargo revenues, Available Seat Kilometres (ASKM), Available Tonne Kilometres (ATKM), Revenue Passenger Kilometres (RPKM), passenger revenue per RPKM, Passenger Load Factor (PLF)) for the two airlines (pre/ post merger) between 2005-06 and 2009-10.

6.1.2 Comparative performance of IAL/ NACIL (narrow-body)

6.1.2.1 Routes rendering cash losses

Route economics for the period 2005-06 to 2009-10 relating to IAL revealed that out of total 742 Services (500 Domestic and 242 International),

- 467 services (63 *per cent)* were not meeting cash costs;
- 185 services (25 *per cent*) were meeting cash costs but not meeting total costs; and
- only 90 services (12 *per cent*) were meeting total cost of operations.

The year wise trend of the profitability of domestic and international services is depicted below:

Table 6.3 – Matrix of services of IAL/ NACIL (narrow-body)

Year	Total Services		Services not meeting cash costs		Services meeting cash costs, but not total costs		Services meeting total costs	
	Dom.	Intl.	Dom.	Intl.	Dom.	Intl.	Dom.	Intl.
2005-06	90	49	23	17	28	12	39	20
2009-10	107	39	63	27	41	10	3	2
2005-10 (Overall)	500	242	326	141	123	62	51	39

Dom. – Domestic, Intl. - International

Between 2005-06 and 2009-10,

- the services not meeting cash cost increased from 26 *per cent* to 59 *per cent* in the domestic sector and 35 *per cent* to 69 *per cent* in the international sector; and
- the services meeting total cost declined from 43 *per cent* to 3 *per cent* in the domestic sector and from 41 *per cent* to 5 *per cent* in the international sector.

In response (February 2011),

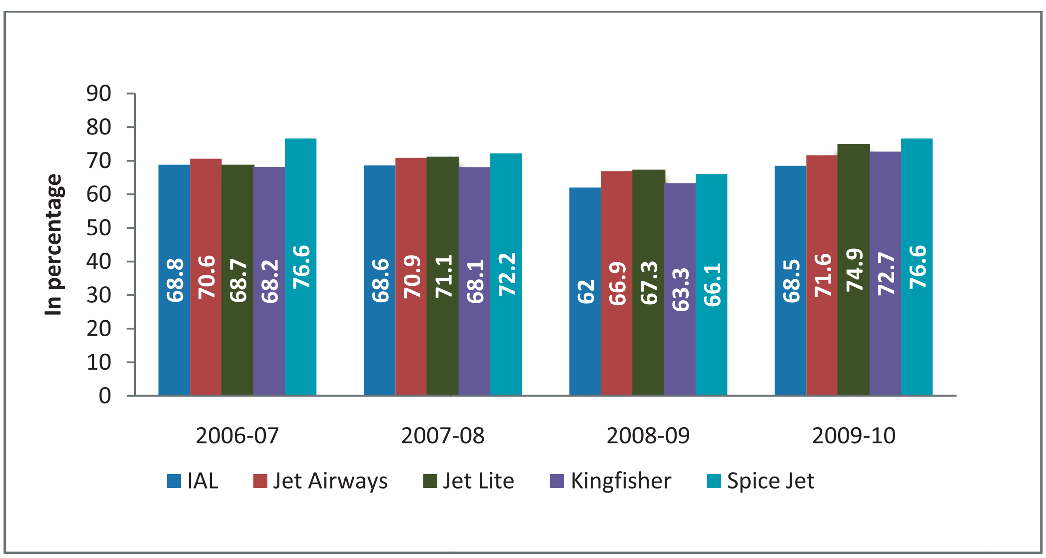
- AI Management stated (February 2011) that during the period under review, access to the Indian market for foreign carriers increased manifold on the one hand while Indian carriers (Jet Airways, Air Sahara and Kingfisher Airlines) were given unrestricted rights to increase domestic capacities besides entry into the international markets. Consequently, Jet Airways, Kingfisher, Jet-Lite and Air Sahara up to a point commenced operations on the very same international routes which were / are served by the Company.
- MoCA replied (February 2011) that during this period, there had been recession in aviation sector in general, and almost every airline had suffered losses. The trend was further accentuated by the high fuel prices in 2008. Several initiatives had been taken in rationalisation of routes.

The Ministry stated (August 2011) that the claim of AI management about the unrestricted rights being provided to Indian carriers to increase domestic capacities was incorrect and stamping out the competition with other carriers in the economic environment was not possible.

6.1.2.2 Unsatisfactory performance vis-a-vis other competitors

A comparison of the performance of IAL with its competitors on various parameters reflects its poor performance on all parameters:

Chart 6.1 – PLF of IAL/ NACIL (narrow-body) and its competitors



Even though 2008-09 was a bad year for all airlines, IAL's position was significantly worse than that of its competitors.

Chart 6.2 – Domestic Market share of IAL/ NACIL (narrow-body) and its competitors

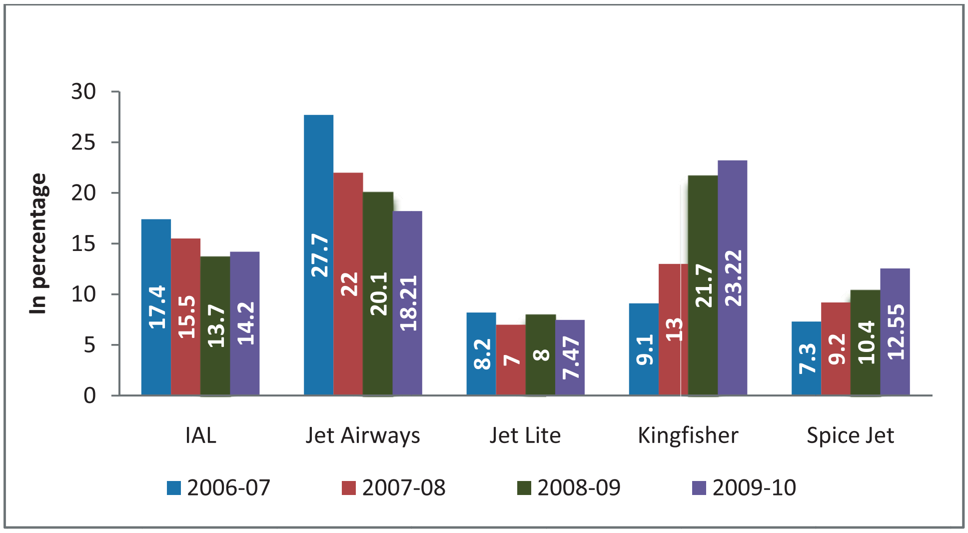
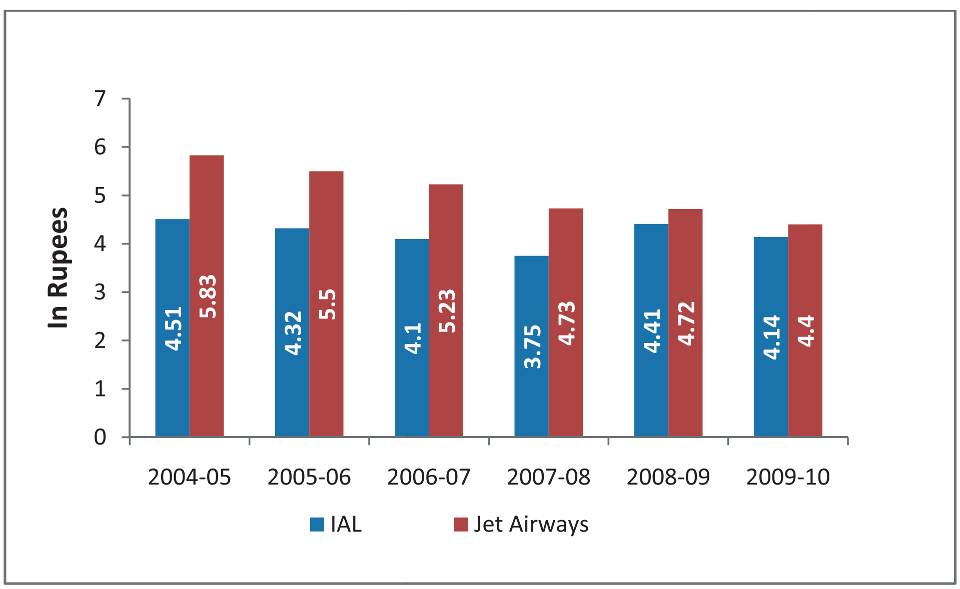
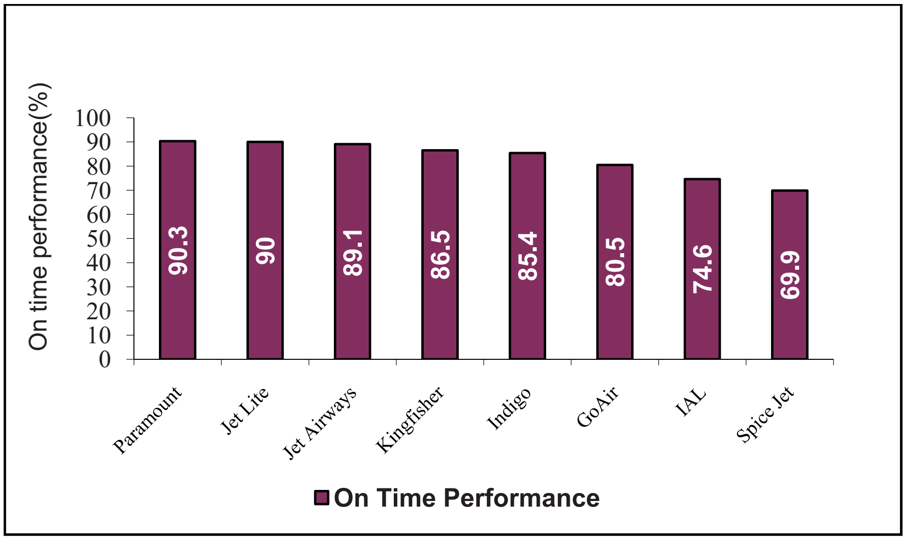


Chart 6.3 – Revenue per RPKM of IAL/ NACIL (narrow-body) and Jet Airways



Between 2006-07 and 2009-10, IAL's domestic market share dropped dramatically as compared to its competitors (primarily Kingfisher and Spice Jet). Passenger revenue per RPKM remained static (although Jet's passenger per RPKM dropped dramatically from 2004-05 to 2009-10).

Chart 6.4 – On-Time Performance of major domestic airlines (July 2010)



IAL's On Time Performance (OTP) was significantly low, compared to both Full Service Carriers (Kingfisher and Jet Airways) as well as Low Cost Carriers (Jet Lite, Indigo, Go Air – except Spice Jet).

The Ministry replied (August 2011) that the observation has been noted.

6.1.2.3 Leased aircraft could not be returned

Although the acquisition project involved return of all leased aircraft, as of March 2010, IAL and its subsidiary, Airline Alllied Services Ltd. (AASL), had 37 leased aircraft. Of these 37 aircraft:

- 11 aircraft were very small capacity aircraft (7 ATR and 4 CRJ aircraft), which could not reasonably have been replaced by the newly acquired aircraft[52].
- 8 aircraft were sold and leased back, evidently as a means of funds generation (in view of the AI's critical financial position)

Of the remaining aircraft, 8 A320 aircraft had been obtained on an operating lease from a lessor (M/s. Aercap) in Netherlands between March 2003 and March 2005. Six of these aircraft were to be returned between March 2008 and October 2009, after completing the extended lease period.

As per the lease agreements, the leased aircraft were to be sent to a mutually acceptable MRO facility for completion of stipulated aircraft checks before return to the lessor. Three of these aircraft were withdrawn from commercial operations by IAL and sent to a Jordan-based MRO between February and July 2008. However, the lessor refused to accept the

[52] To that extent, the assumption in the project report that all leased aircraft would be returned was faulty.

return of the aircraft, by raising disputes on their physical condition and documentation and raised claims of huge settlement amounts.

Finally, one aircraft was returned to the lessor in May 2009 after a **"buy-out package[53]"** (viz. payment of compensation to the lessor by IAL, in exchange for waiving all liabilities associated with the aircraft "redelivery conditions") of $ 2.7 million. In respect of the remaining two aircraft and three aircraft, the lessor demanded buyout packages ranging from $ 5 to $ 10 million and $ 19.63 million respectively.

In all fairness, this situation could not have been easily foreseen by IAL; it is not clear whether cannibalisation of aircraft spares also contributed, at least partly, to these difficulties.

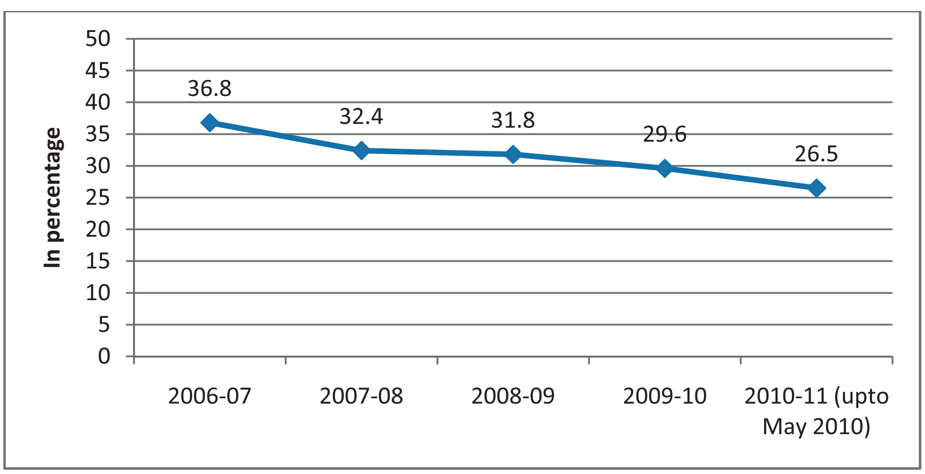
However, this highlights the danger of undue dependence on leasing. When the leasing market turns adverse (with difficulties in obtaining new customers for leased aircraft), the lessor would naturally try to protect its commercial interests, by utilising all possible contractual loopholes to discourage/ prevent IAL from returning the leased aircraft.

The Ministry stated (August 2011) that the matter regarding leasing of the aircraft had also been discussed by the board of Air India, and noted the audit observations.

6.1.2.4 Cargo operations

The market share of IAL in cargo operations dropped dramatically from 36.8 per cent in 2006-07 to 29.6 per cent in 2009-10, as depicted below:

Chart 6.5 – Market share of IAL/ NACIL (narrow-body) in Cargo operations



The conversion of five B737 aircraft into freighter aircraft between August 2007 and July 2008 did not benefit IAL.

[53] The term "buy-out package"/ compensation does not, appear in the lease contract itself, but arises only at the time of re-delivery of leased aircraft. This could be construed as a form of pressure tactics applied by the lessor.

In sum,

- ***Route economics revealed that most of IAL's services were not meeting cash costs or total costs, both in domestic and international sectors.***
- ***The performance of IAL vis-a-vis its competitors on various parameters (PLF, domestic market share, Passenger Revenue per RPKM) was consistently poor. IAL's On-time Performance – a critical parameter of service – was low, compared to both full service carriers and low cost carriers. Further, the market share of IAL in cargo operations dropped dramatically, despite conversion of five B737 aircraft into freighter aircraft.***

The Ministry noted (August 2011) the audit observation, and also stated that the volume of cargo operation had been scaled down for the reasons mentioned by audit.

6.1.3 Comparative performance of AIL

6.1.3.1 Route Profitability Analysis

During 2005-10, the erstwhile AIL operated ten international routes having 26 sub-routes (destinations) which were reduced to 19 sub-routes in 2009-10. Of the ten routes operated during 2005-10,

- six routes (India/USA, India/Canada, India/UK[54], India/East Africa, India/ South East Asia and India/China) were incurring losses since 2001-02;
- only two routes (India/Far East Asia and India-Gulf/Middle East) made profits till 2005-06.;
- The two new sub-routes introduced in 2009-10 that of India-Frankfurt and India–Washington also incurred losses.
- All the routes were loss making in 2009-10 as indicated below:

Table 6.4 – Profitability of Routes operated by AIL / NACIL (wide-body) during 2005-10

(Rs. in crore)

	2005-06	2006-07	2007-08	2008-09	2009-10
India/USA	-552.44	-1003.02	-1452.18	-2842.86	-1522.15
India/Canada	-61.92	-144.34	-228.96	-191.95	-355.21
India/UK	-115.09	-234.63	-348.18	-272.66	-514.87
India/East Africa	-6.57	-23.56	-30.79	-79.28	-34.39
India/South East Asia	-94.66	-152.43	-97.67	-5.99	-51.49

[54] Except in 2004-05

	2005-06	2006-07	2007-08	2008-09	2009-10
India/China	-18.31	-64.31	-85.67	-90.38	-66.98
India/Gulf Middle East	229.91	90.81	-262.17	-566.53	-688.13
India/Far East Asia	7.8	-152.1	-158.72	-482.59	-207.02
India/Paris	--	--	--	-54.95	-331.08
India/Bangladesh	--	--	--	-0.57	--

The Ministry replied (August 2011) that the observation has been noted.

6.1.3.1.1 India /USA Route

Scrutiny of routes revealed that AIL was consistently making losses on the USA route. The operational loss in USA route, where it was flying to four sub-routes (destinations) is given below:

Table 6.5 – Profile of operations by AIL/ NACIL (wide-body) on India-USA Route

(Rs. in crore)

Particulars	2005-06	2006-07	2007-08	2008-09	2009-10
Operating loss on India/USA route	**-552**	**-1003**	**-1452**	**-2843**	**-1522**
Total operating loss[55] of AIL on routes operated	-611	-1684	-2664	-4588	-3743
Percentage of Operating loss of India/USA route to the Total operating loss of AIL on routes operated (%)	90	60	55	62	41

Table 6.6 – Performance of sub routes of India-USA operations

(Rs. in crore)

Sub routes of India-USA route	2005-06	2006-07	2007-08	2008-09	2009-10
New York	**-73.84**	**-265.57**	**-686.23**	**-1499.71**	**-482.01**
Newark	**-125.24**	-217.73	-317.46	-642.85	-563.95
Chicago	**-113.17**	-240.52	-293.77	-496.65	-328.34
Los Angeles	-240.19	-279.19	-154.68	-203.65	-
Washington	-	-	-	-	-147.85

[55] The operating loss for each of the years is the sum total of the profit/loss incurred on all the routes operated by AIL.

The India/USA route was the single biggest factor adversely affecting AIL's operations. The grossly exaggerated nature of the assumption relating to increased yield on account of non-stop USA operations (projected in the revised project report for 50 long range aircraft) is clearly revealed.

The Ministry replied (August 2011) that there was recession and high oil prices during the said period and most of the airlines in the world had incurred losses on operating flights to US. However, the reply is silent about the exaggerated assumptions relating to yield on non-stop USA operations.

6.1.3.1.2 New York sub-route

Even though AIL was incurring losses on the New York sub-route, it increased the frequency of operations from 725 flights (2005-06) to 2183 flights (2008-09), but the PLF declined from 68.5 *per cent* (2005-06) to 58.8 *per cent* (2008-09) (although AIL had deployed newly acquired B777-200LR aircraft on this sub-route from mid 2007-08 onwards by operating daily non-stop flights). The total operating loss on this sub-route, which was Rs. 73.84 crore in 2005-06, increased to Rs. 482.01 crore in the year 2009-10.

Further, AIL continued to operate the New York sub-route under loss without any major curtailment of frequencies. Incidentally, Jet Airways, which was operating to San Francisco withdrew (January 2009) its operations in an effort to right size capacity on the North American routes, and leased its seven long haul B777 aircraft to other airlines. It is only in 2009-10, that the frequency of AIL operations on the New York sub-route was reduced to 1219 flights, the PLF stood at 67.9 *per cent* and the total operating loss on this sub-route was Rs.482.01 crore.

In response, the Management replied (February 2011) that AIL's operations on the India-USA route were continuously reviewed and various measures were taken to improve the operating margins, which had produced gratifying results; and the route was now generating cash surpluses, *i.e.* in 2010-11. The Ministry stated that AIL enjoyed market share of about 23 *per cent* on this route during 2009-10 and that it was necessary to continue the operations to USA to retain market share/ airports slots.

The Ministry concurred (August 2011) with the response given by AIL.

6.1.3.1.3 Gulf and Middle East Route

Till 2005-06, AIL was making profits on all the ten sub-routes in Gulf/ Middle-East except in Al-Ain. The operations on some of the routes were withdrawn and handed over (April 2005 to February 2007) to its low cost subsidiary, Air India Charters Limited (AICL). In 2007-08, AIL operated seven sub-routes, out of which only two sub-routes made profits (Abu Dhabi and Muscat). In 2009-10, all the five sub-routes operated were under losses.

Kuwait sub-route

AIL was making profit intermittently on this sub route till 2005-06, which turned loss-making in subsequent years. Till January 2007, AIL was operating flights with dry leased aircraft. However, from February 2007, it deployed an additional wet leased aircraft to increase frequency of its operations. The frequency of operations was reduced in December 2007/ January 2008 due to withdrawal (November 2007) of the wet leased aircraft by the lessor. Subsequently, AIL withdrew (October 2008) all flights from the Kuwait sub route. Out of the total operating loss of Rs. 59.60 crore during 2007-08 on Kuwait sub-route, the wet lease hire charges accounted for 88.05 *per cent*, i.e. Rs. 52.48 crore. Although there was an increase in traffic in 2008-09 from Mumbai/ New Delhi to Kuwait, AIL did not reintroduce flights to Kuwait from these cities when its competitor (Jet Airways) commenced (January 2008) operations to Kuwait from New Delhi and Kochi.

Riyadh sub-route

Riyadh sub-route was in profit in 2005-06, but incurred operating loss during 2006-10. Frequent delays/ rescheduling/ misconnections by 372 times during the period 2006-09 adversely affected the PLF which declined from 81.40 *per cent* (2006-07) to 63.6 *per cent* (2008-09). Despite the operating loss, AIL increased the frequency of flights during 2008-09 which further increased the losses. During the year 2009-10, AIL operated 1621 flights on the Riyadh sub-route but there were delays/ rescheduling/ misconnections on 232 occasions and the PLF was 66.2 *per cent*.

Management attributed (April 2010) the increased losses to the liberal bilateral entitlements, entry of private Indian carriers on the routes operated by AIL and access to interior points in India to other foreign carriers and increase in ATF cost.

In our opinion, besides the chronic operational deficiencies of AIL, the key reasons for low route profitability were the liberal increase in bilateral entitlements which benefited foreign carriers with large volumes of 6th freedom traffic (described elsewhere) and the failures of AIL to contain/ reduced losses (especially on the India/ USA route) through appropriate route rationalisation/ curtailment/ withdrawal of services on chronically loss making routes, revenue management strategies etc.

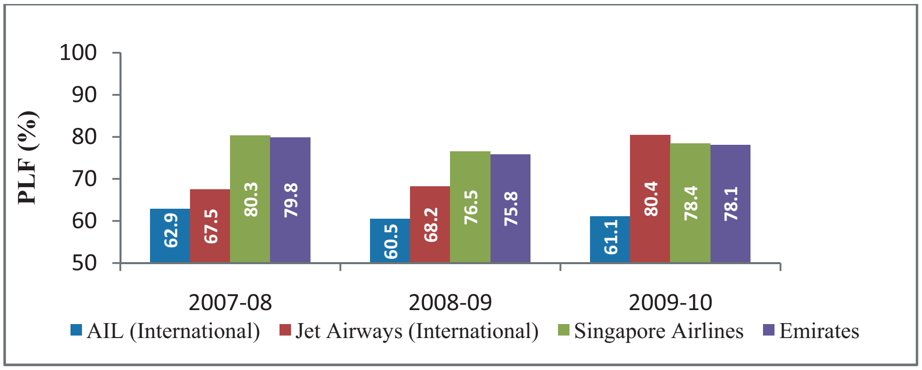
The Ministry replied (August 2011) that route rationalization was undertaken, and admitted that liberal bilateral agreements which benefitted foreign carriers in terms of large volumes of 6th freedom traffic was inevitable. It also stated that AI's non stop US flights were preferred over any 6th freedom arrangement for sheer convenience of passengers.

The Ministry's reply is not tenable, as it is not borne out either by AI's profitability figures on this sector or by the frequency of operation, which has come down.

6.1.3.2 Poor PLF vis-a-vis competitors

The PLF of AIL on international operations declined from 73.3 *per cent* in 2003-04 to 61.1 *per cent* in 2009-10. By contrast, the PLF of Jet Airways increased from 19.4 *per cent* in 2003-04 to 80.4 *per cent* in 2009-10. The PLF of Singapore Airlines and Emirates were also much better than that of AIL.

Chart 6.6 – Passenger Load Factor of AIL/ NACIL (wide-body) and its competitors



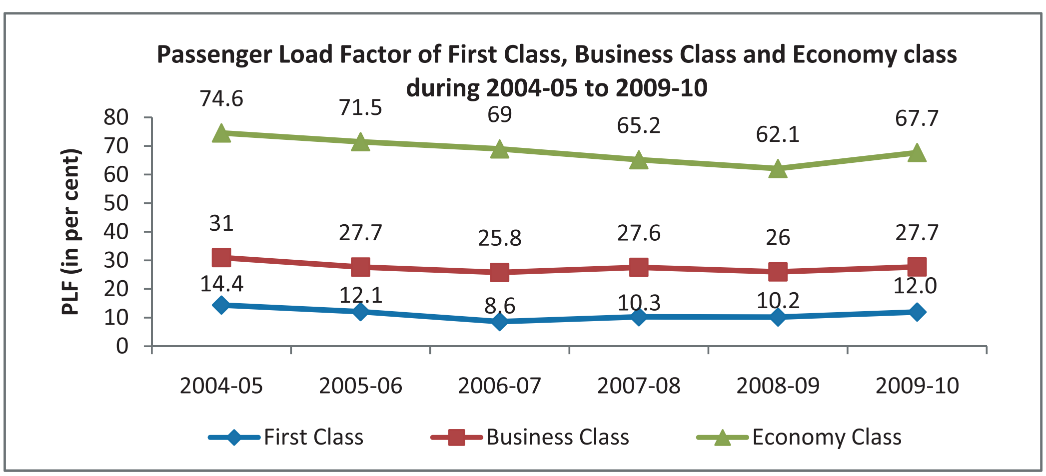
The Management stated (February 2011) that the comparison of AIL's PLF with Singapore Airlines and Emirates was not fair, as they had hubs in their own countries. However, with the development of hub at New Delhi, higher PLF would be achieved in 'Air India'.

The Ministry noted (August 2011) the audit observation.

6.1.3.3 PLF in First Class and Business Class

The aircraft operated by AIL on the international routes normally had a configuration of Economy, Business/ Executive and First class, of which Business/Executive and First Class represent high yielding business. There was a substantial decrease in the PLF of AIL flights in First class from 14.4 *per cent* (2004-05) to 12 *per cent* (2009-10) and in Business/ Executive class from 31.0 *per cent* (2004-05) to 27.73 *per cent* (2009-10).

Chart 6.7 – Passenger Load Factor of First class Business class and Economy class of AIL/ NACIL (wide-body) during 2004-05 to 2009-10



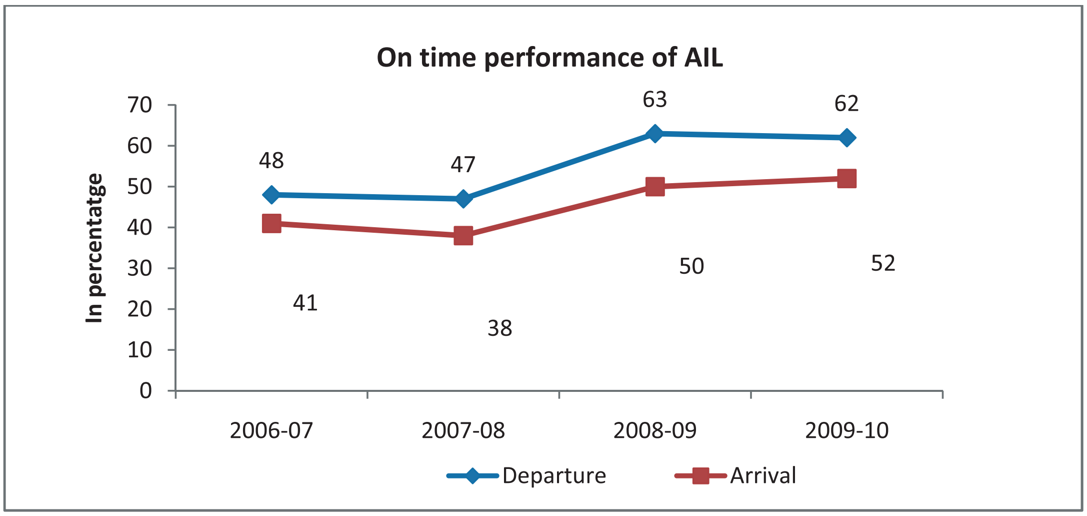
The Management stated (March 2010) that they were aware of the need to improve the seat factors in First and Business/ Executive class and several initiatives had been taken to achieve this objective. The Management further replied (February 2011) that during 2010-11 (April – December), the PLFs in business and first class were 25 and 22 *per cent* respectively and added that various marketing schemes were offered to improve the PLF on this segment.

The Ministry noted (August 2011) the audit observation.

6.1.3.4 On Time Performance

On-time performance of AIL flights continued to be unsatisfactory for the period 2006-07 to 2009-10.

Chart 6.8 – On-Time Performance of AIL/ NACIL (wide-body)



Source: Information obtained from the AI Management.

The Ministry stated that the Company was operating with an age old fleet, which was the cause of unsatisfactory 'on-time' performance; and with the aircraft acquisition, PLF and OTP had improved.

While noting the recent improvement in PLF and OTP, we believe that, in addition to the hub factor, chronic operational deficiencies are also major factors in the non-achievement of high PLF and OTP.

The Ministry noted (August 2011) the audit observation.

6.1.3.5 Quality of Service

'Air India' carried out a study to ascertain the strength and weakness of the Air India brand, through a leading market research agency, *viz.*, Indian Market Research Bureau (IMRB) in February/March 2009. The study revealed that in the international arena, the fliers were demanding more than the basic facilities with overall travelling experience and comforts and that the Air India brand was no longer preferred as it was not meeting the above standard. The study further stated that the services of 'Air India' were not oriented towards customer satisfaction, the personnel had an indifferent "sarkari" attitude and brand Air India was kept as a substitute airline to travel.

The customer perception of the other branded airlines *vis-à-vis* Air India brand is tabulated below:

Table 6.7 – IMRB survey of Customer perception of AI and other airlines

	Air India	Kingfisher	Jet Airways	Singapore Airlines	Lufthansa	British Airways
Ambience	Ordinary, Outdated	Luxurious, Glamorous	Corporate	Lively, Informal	Professional, impeccable	**Impeccable, Comfortable**
Service	Apathetic attitude, Grudging	King size service,	Professional Attentive, Smart, Pleasant	Cutting edge	Quick, Superlative efficiency	**Punctual**
Personnel	**Elderly, Unpleasant, Unresponsive, Unattractive**	**Young Glamorous, Friendly, Obliging, Well dressed**	**Professional, Efficient, Classy, Friendly, Responsive**	**Young, Cheerful, Warm**	**Professional Responsive Accommodating, Courteous**	**Polished, Hospitable**

Further, SkyTrax[56] ratings for 'Air India' during 2009 in respect of various parameters (services for first class, business class and economy class at airport, lounges, on board product for long haul, short haul, regional routes, *etc.)* were between 1 – 3 stars (out of 5 stars). In comparison, the ratings for the other Indian private competitors, *viz.* Kingfisher Airlines and Jet Airways as well as some foreign competitors, *viz.* Emirates, British Airways, Singapore Airlines, ranged between 2 – 5 stars (out of 5 stars) on all counts.

The Ministry noted (August 2011) the observation.

6.1.3.6 Inadequate publicity and sales promotion

AI did not adequately advertise the induction of new aircraft with new routes/ sectors and promotional schemes, especially in a scenario of aggressive advertising by its competitors. The amount spent towards publicity and sales promotion by the AI *vis-à-vis* other airlines for the period 2007-10 was as under:

[56] Skytrax, an international airline and air travel industry rating agency, provides quality certification of airline product and service standard, competitive performance analysis and other services on a year to year basis.

Chart 6.9 – Expenditure on Publicity and Sales Promotion

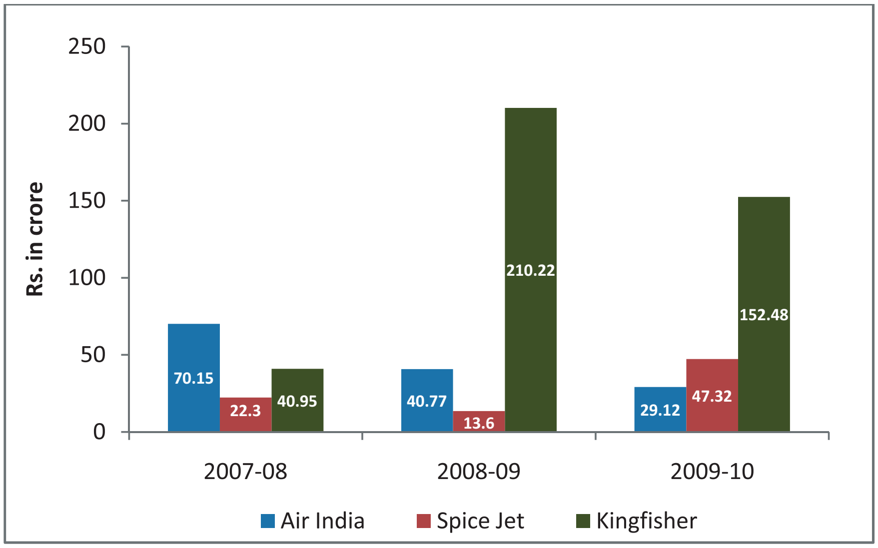
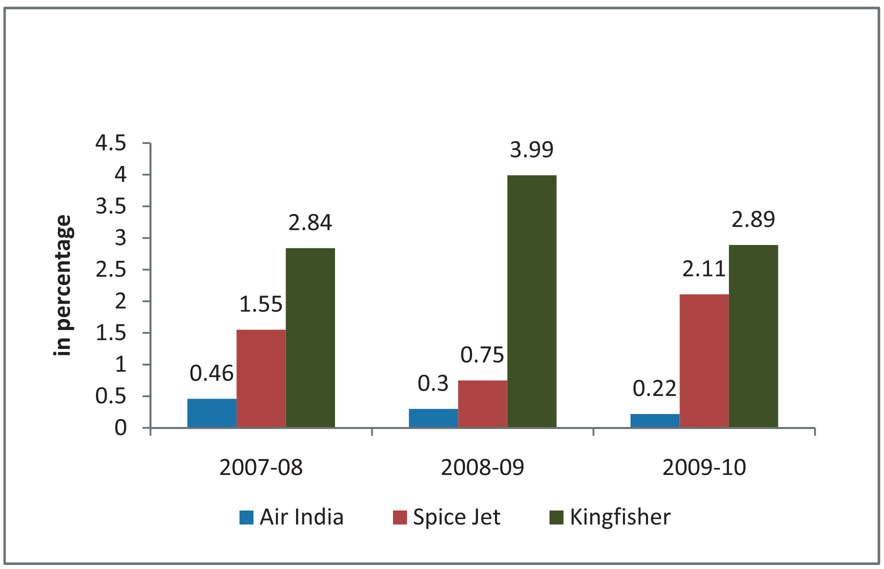


Chart 6.10 – Percentage of expenditure on Publicity and Sales Promotion to Operating Revenue



As against the industry norm of 1.5 *per cent* to 2 *per cent*, the percentage of publicity and sales promotion expenditure to the revenue earned for 'Air India' ranged between 0.22 *per cent* and 0.46 *per cent* whereas in respect of private airlines, the percentage ranged between 0.75 *per cent* and 3.99 *per cent.* Further, expenditure on publicity and sales promotion by 'Air India' decreased from Rs.70.15 crore in 2007-08 to Rs. 29.12 crore in 2009-10, while private airlines increased their expenditure on publicity and sales promotion during the same period.

The Ministry admitted (February 2011) that AIL had very low spending on advertising which was mainly on account of cost saving measures adopted by 'Air India'.

The Ministry noted (August 2011) the audit observation.

6.1.3.7 Negligible sales from website

In AIL, the web sales were through an IT system called the Internet Booking Engine (IBE) established in 2002. During 2007-08,'Air India' revamped and changed the website to make it user friendly, but the percentage of web sales to total sales was poor and it never exceeded 2.63 *per cent* during 2005-10. On the other hand, the web sales of Jet Airways accounted for 11 *per cent* of total sales (2008-09). Further, AI failed to have an integrated website till 2010.

The Management replied (February 2011) that the integrated web-site was achieved in February 2010, and that the web sales for domestic and international had grown considerably. With the PSS implementation from end January 2011, there would be a single back end like other international airlines. Further, several additional incentives were being introduced to improve web-sales which are under implementation.

We note the recent efforts made to improve the web sales, but the fact remains that web sales had increased marginally to 2.63 per cent of total sales in 2009-10 and AI's efforts had not translated into any major increase in web sales.

The Ministry noted (August 2011) the audit observation.

6.1.3.8 Code Share utilisation

The selling of the seats on a flight by a different (operating) airline by a "marketing" airline, through a different code is called code share arrangement. As the utilisation of code share seats by AIL was low (40-45 *per cent)*, the Strategic Group in its meetings held in August 2008/ October 2008 discussed the need to market these seats more aggressively by the Sales and Marketing unit. By increasing the code share utilisation to 70 *per cent*, AIL could earn an additional Rs. 60 crore per *annum*. However, it was observed in audit that during 2009-10, the code share seat utilisation was only 43.48 *per cent*.

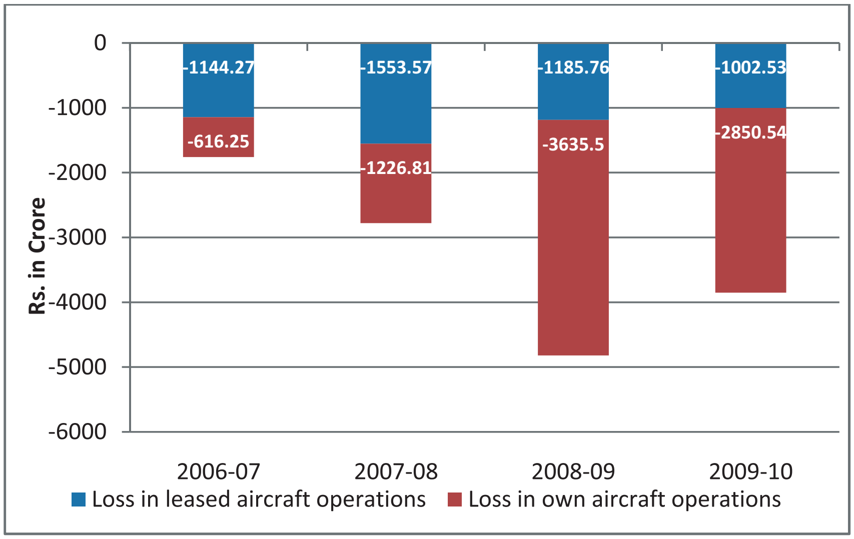
The Management replied (February 2010) that the marketing airline was always at a disadvantage, as it could not match the practices / benefits extended to passengers by the operating airline.

The Ministry noted (August 2011) the audit observation.

6.1.3.9 Hire of Aircraft

During the period 2006-10, AIL returned 24 lease aircraft but entered into a fresh lease for 17 aircraft mainly to "retain market share" and to "bridge the capacity gap". However, AIL made operational losses on the leased aircraft for the period 2006-07 to 2009-10; while the total revenue earned on leased aircraft operations was Rs. 9,882 crore, the expenditure incurred was Rs. 14,786.26 crore, resulting in an operational loss of Rs. 4,886.13 crore. The percentage of losses on leasing operations to total operational losses of AIL during 2006-10 ranged between 24.59 *per cent* and 64.99 *per cent*, as depicted below:

Chart 6.11 – Operational loss of AIL/ NACIL (wide-body)in respect of leased and own aircraft during 2006-10



We reviewed eleven lease aircraft proposals, out of which five were executed prior to 2006-07 and six during 2006-10 and observed that in respect of seven proposals[57], leasing had been justified with negative returns for 'maintaining market presence' or slot utilisation at foreign airports. The proposals were approved by the Board (including GoI Directors), but actual performance was not reviewed subsequently by the Board.

In response, Management (April 2010) stated that liberal bilateral rights and grant of access to Indian private carriers on international sectors resulting in increased capacities coupled with fuel increase and global economic recession in 2008-09 had impacted the leased operations of AIL/'Air India'. We do not agree; the lease proposals were approved to retain the market share and "bridge the capacity gap" which, however, did not fructify.

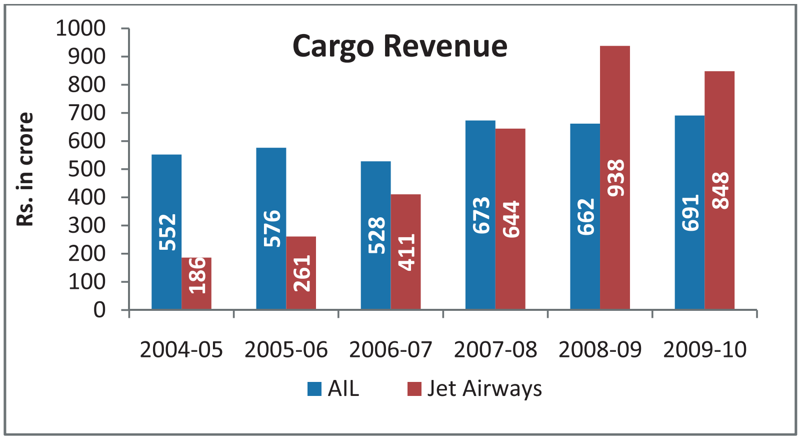
The Ministry agreed (August 2011) to the observations and stated that the airline was making attempts to reduce lease capacity.

6.1.3.10 Cargo carriage

Cargo carriage by AIL was on a declining trend over the years vis-a-vis its competitors.

[57] Three B777-200ER (dry), two B767-300ER(wet), and one each of A310-300(wet) and B747-400(dry)

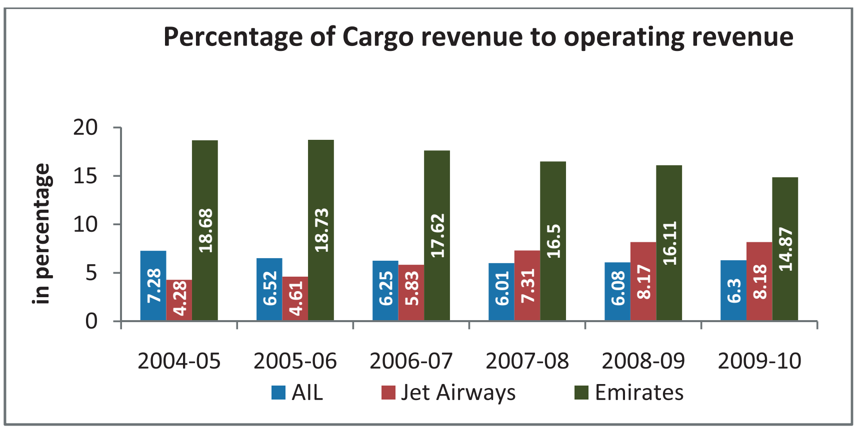
Chart 6.12 – Cargo Revenue of AIL /NACIL (wide-body) and Jet Airways



**Jet Airways started international operations from 2003-04.*

Source: Figures for AIL as supplied by the AI Management and for Jet Airways and Emirates as per their Annual Reports.

Chart 6.13 – Percentage of Cargo revenue to Operating Revenue of AIL/ NACIL (wide-body) and Jet Airways and Emirates



AIL converted four passenger aircraft (including two leased aircraft) into freighter aircraft at a cost of Rs. 168.30 crore for its own dedicated freighter operations on the Paris, Frankfurt, Far East and South Asian routes. The freighters were inducted between June 2007 and December 2008, but cargo freighter operations were suspended in September 2009, since AIL incurred a loss of Rs. 270.62 crore on these operations. In fact, as of April 2010, AIL continued to incur lease charges of approximately Rs. 2.27 crore p.m. on the leased freighter aircraft, despite no cargo operations from October 2009 onwards.

AIL Management stated (February 2011) that the freighter operations were affected by technical delays from the beginning, affecting scheduled integrity, and other factors (hike in fuel prices, global economic slowdown and intense competition) added to the losses, forcing withdrawal of freighter operations. The Ministry stated additional steps were being taken to improve cargo profitability, and improvement of belly space utilisation in passenger aircraft would be the area of current focus.

The Ministry noted (August 2011) the observation and stated that the volume of cargo operation had been scaled down.

In sum

- ***Even earlier, most routes (North America, UK, SE Asia etc.) of the erstwhile AIL were incurring losses, and only the Gulf/ Middle East and Far East Asia routes made profits till 2005-06. By 2009-10, all routes were loss-making, the single largest loss-making routes being the India/ USA route, which contributed between 41 to 90 per cent of AIL's total operating losses during the period 2005-06 to 2009-10. This clearly revealed the grossly exaggerated nature of assumptions relating to increased yield on account of non-stop operations (projected in the revised fleet acquisition report). Besides this, the main reasons for low route profitability were the liberal increase in bilateral entitlements, which benefited foreign carriers with large volumes of 6th freedom traffic and the failures of AIL to contain/ reduced losses (especially on the India/ USA route) through appropriate route rationalisation and other measures etc.***

- ***AIL's PLF suffered drastically vis-a-vis its competitors. In particular, the PLF of AIL flights in first class and business class declined from already low figures of 14 per cent and 31 per cent (2004-05) to abysmal levels of 12 per cent and 28 per cent respectively. Considering the widely recognised view that occupancy of a single seat in business/ first class can financially offset several vacant seats in economy class, these low PLFs in business/ first class are unsustainable. Similarly, AIL's On-time Performance for arrival and departure was dismally low at 62 and 52 per cent respectively during 2009-10.***

- ***Market surveys of customer perception revealed that Air India was no longer a preferred brand, and that it was not adequately oriented towards customer satisfaction. Expenditure on publicity and sales promotion was negligible.***

6.2 Financial performance

6.2.1 Overall position

The overall financial position of IAL/ AIL and the merged entity has been abysmally poor during the period from 2004-05 to 2009-10. Even in 2004-05/ 2005-06 (when the aircraft acquisition was still under way), the financial position of the airlines was not very promising. This deteriorated drastically post-merger (2007-08 onwards).

Table 6.8 – Key financial indicators of AIL/ IAL/ AI

Rs. in crore

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Revenues						
Operating Revenue	12921	14600	14425	13638	13224	13109
Other Income	72	431	1990	1619	255	294
Total Revenue	12993	15031	16415	15257	13479	13402
Expenses						
Operating Expenditure	12810	14924	17240	17854	18896	16581
Interest and financial charges	67	105	276	702	1666	2434
Other Expenditure and adjustments	-21	-71	-328	-	106	21
Total Expenditure	12856	14958	17188	18556	20668	19036
Profit						
Cash Profit	888	768	21	-1465	-4322	-4163
Net Profit after tax	162	64	-688	-2226	-5548	-5552
Liabilities						
Working Capital Loan	889	2181	5595	9924	16328	18524
Loans for Acquisition	776	1542	2995	8458	14575	19899
Total Borrowings (inc. other loans)	1694	3961	9009	18413	30908	38423
Net Worth	-578	-188	-875	-2081	56	-4554

Note: For 2004-05 to 2006-07, figures in respect of IAL and AIL have been summed up, while figures for 2007-08 to 2009-10 are in respect of the merged entity (AI).

In brief:

- Revenues showed a static trend, and expenditure increased dramatically;
- Interest burden, which was nominal in 2004-05, increased 36 times to Rs. 2434 crore[58] in 2009-10 and working capital loan went up nearly 21 times from 2004-05 to Rs. 18524 crore in 2009-10;
- Cash profits and marginal net profits in 2004-05 and 2005-06 turned into substantial cash losses and net losses;

[58] Representing 18 per cent of total revenues in 2009-10

- The net worth of the entities, which was negative till 2007-08, was made positive in 2008-09 through a revaluation of fixed assets by Rs. 8,028 crore, but again became hugely negative in 2009-10;
- As of 2009-10, the total borrowing was 2.87 times the total revenue; even the working capital loan was 1.38 times the total revenue.
- GoI's equity infusion of Rs. 325 crore in 2005-06 into the erstwhile IAL and Rs. 800 crore in 2009-10 to AI represented a mere drop in the ocean.

MoCA and AI stated (February 2011) that the revaluation of immovable properties was done so as to leverage value from assets, as per the recommendations of the consultant (Accenture). Further, the revaluation improved the company's net worth, and helped it to mitigate deferred tax liability. The fact, however, remains that this was merely a book adjustment, and represented a totally unrealised gain.

In addition, the CAG's comments (under Section 619(4) of the Companies Act, 1956) on the accounts of NACIL for 2009-10 pointed out an understatement of loss by Rs. 3,039 crore, and that the "true and fair view" expressed by the statutory auditors on NACIL's financial statements was not sustainable:

- Rs. 196 crore on account of overstatement of prepaid expenses (payments to lessors towards maintenance charges of aircraft); and
- Rs. 2843 crore by not writing down the net deferred tax assets of earlier years.

Clearly, the financial position of AI is unsustainable, and the merged airline is heading towards, if not already in, a debt trap.

6.2.2 Cost Profile

A summary profile of key cost components of the merged airline, as well as its individual components (erstwhile IAL/ AIL) is depicted below:

Table 6.9 – Profile of key cost components of AIL/ IAL/AI

(Rs. in crore)

	Total		IAL/ NACIL (narrow-body)		AIL/ NACIL (wide-body)	
	2005-06	2009-10	2005-06	2009-10	2005-06	2009-10
Fuel and oil	5107	5015	1966	2031	3141	2984
Employee costs	2352	3357	1108	1672	1244	1685
Maintenance and repair costs	1353	1229	696	935	657	294
Passenger	566	483	188	173	378	310

	Total		IAL/ NACIL (narrow-body)		AIL/ NACIL (wide-body)	
	2005-06	2009-10	2005-06	2009-10	2005-06	2009-10
Amenities						
Leasing/ hire charges	1124	1177	180	411	944	766
Interest and financing	106	2434	22	919	84	1515
Depreciation	703	1390	297	506	406	884
Employees (in numbers)	33575	29630	18219	16380	15356	13250

Our analysis indicates the following:

Table 6.10 – Key issues on Cost Components

Cost Item	Audit Analysis
Employee Costs	• Both for the erstwhile AIL/ NACIL (wide-bodied) and IAL/ NACIL (narrow-bodied) entities, employee costs were a critical factor during the period 2005-10. Despite a substantial reduction in number of employees by 13.71 *per cent* and 10.09 *per cent* in AIL and IAL, the total employee costs of AIL and IAL went up from Rs. 1244 crore to Rs. 1685 crore and from Rs. 1108 crore to Rs. 1672 crore respectively during this period. The per-employee costs of AIL and IAL went up from Rs. 8.10 lakh p.a. to Rs. 12.72 lakh p.a. and from Rs. 6.08 lakh p.a. to Rs. 10.21 lakh p.a. respectively. ***This is completely contrary to the worsening financial position of the two entities during this period, and clearly indicates the need for a complete overhauling of the remuneration structure to better synchronise it with financial and operational performance.***
Fuel Costs	• Fuel/ oil costs were more or less determined by the fluctuations in ATF prices. However, in 2009-10, there was a substantial drop in AIL's fuel costs of more than Rs. 1,000 crore (Rs. 4034 crore in 2008-09 and Rs. 2984 crore in 2009-10), apparently driven by route rationalisation and due to Fuel Efficiency Gap Audit (FEGA) as well as reduction in ATF prices.
Maintenance and Repair Costs	• The maintenance and repair costs of AIL came down substantially during 2005-10. However, in the case of IAL, it increased substantially from Rs. 696 crore to Rs. 935 crore.
Passenger	• Expenditure on passenger amenities (including food costs, passenger accommodation costs on account of delays/

Cost Item	Audit Analysis
Amenities	cancellations etc.) in respect of both AIL and IAL showed a downward trend. ***This is a disturbing trend, as passenger service is critical to the image of a commercial full-service airline. Instead of excessive cost-control in this area (which is apparently easy to "cut"/ address, but could adversely affect customer satisfaction), IA should focus cost cutting efforts more on other areas.***
Interest	• The interest burden for both AIL and IAL was marginal in 2005-06, but has spiralled to Rs. 2434 crore in 2009-10. The major jump in respect of AIL was in 2008-09 (when it more than doubled from Rs. 553 crore in 2007-08 to Rs. 1145 crore in 2008-09). ***Such enormous increase in interest burden is both on account of enormous increase in working capital, as well as the debt-funded fleet acquisition. A debt trap is not far off, unless substantial infusion of equity (coupled with dramatic improvements in financial and operational performance) takes place.***
Depreciation	• Depreciation for AIL and IAL has more than doubled during 2009-10 from Rs. 406 crore to Rs. 884 crore and from Rs. 297 crore to Rs. 506 crore respectively. This increase in depreciation is largely on account of replacement of old aircraft, and induction of new aircraft. Since this is a non-cash expense, this does not have immediate adverse impact. However, in the medium term, it would adversely affect the profit/ loss and thus the borrowing capacity of AI.

6.2.3 Revenue profile

A summary profile of key revenue parameters is depicted below:

Table 6.11 – Key Revenue parameters

(Rs. in crore)

	Total		IAL/ NACIL (narrow-body)		AIL/ NACIL (wide-body)	
	2005-06	2009-10	2005-06	2009-10	2005-06	2009-10
Passenger Revenue	10397	9150	4709	4496	5688	4654
Cargo Revenue	818	691	242	198	576	493

	Total		IAL/ NACIL (narrow-body)		AIL/ NACIL (wide-body)	
	2005-06	2009-10	2005-06	2009-10	2005-06	2009-10
Total revenue (including Others)	15031	13402	5786	5371	9245	8031

6.2.4 Increase in Working Capital

The stated working capital of AIL (i.e. current assets less current liabilities) remained positive throughout the period 2009-10 – ranging from Rs. 1057 crore in 2005-06, going up to Rs. 2847 crore in 2006-07 and coming down to Rs. 529 crore in 2009-10. However, this should be read with the fact that sundry debtors increased from Rs. 1448 crore in 2005-06 to Rs. 2144 crore in 2009-10, indicating difficulties in collection.

Further, the stated working capital of AIL did not reflect the huge increase in the working capital loan[59] from Rs. 2056 crore in 2005-06 to an enormous figure of Rs. 12,679 crore in 2009-10 (as against operating revenues of just Rs. 7824 crore). Clearly, even in 2005-06, erstwhile AIL's funds/ liquidity position was precariously poor, while in 2009-10, in case of merged entity, it was teetering on the brink of disaster.

As of July 2010, AI had availed of an overall amount of Rs. 19207 crore as Working Capital loan, of which Rs. 18,162 crore was utilised as working capital, and Rs. 1,045 crore was utilised for aircraft acquisition payments. The main items on which the working capital loans was utilised as of June 2010 were fuel (Rs. 5,639 crore), aircraft repairs and refurbishment (Rs. 4,058 crore) interest/ repayment of old aircraft loans (Rs. 3,732 crore), leasing (Rs. 1,416 crore) and wages (Rs. 1,348 crore).

Clearly, the Directors on the AI Board (especially the Government Directors) should have been aware much earlier that such enormous increases in working capital loan limits (without a corresponding increase in operational revenues) were indicative of a major liquidity problem.

The Ministry replied (August 2011) that the increase in working capital limits to extreme proportion was noted by the Government Directors and Independent Directors of the NACIL/AIL Board, but they had little option, keeping in view the cash flow position of the airline.

The reply is not acceptable, as the Directors on the AIL Board should have been aware of the alarming situation that AIL would be facing in future.

[59] Which was depicted under unsecured loans.

6.3 Real-time Revenue Management Systems

In the era of deregulated air fares, yield management is a critical aspect of revenue generation for the airline industry. Yield management involves strategic control of inventory (seats in the case of airlines) to sell it to the right customer at the right time for the right price; this process can result in price discrimination and market segmentation. This is a complex activity, involving use of sophisticated IT systems and complex revenue models, as well as experienced revenue management strategists. There are different categories of revenue management software:

- **Leg/ segment revenue management tools** – which allocate seats among different fare buckets;
- **PNR O&D data based systems** – which represents a substantial improvement over leg/ segment revenue management systems and examine how the route network should be designed, based on analysis of PNR data;
- **Real-time dynamic pricing systems** – which go further in terms of the granularity of market/ customer satisfaction.

Although IAL never used an Automated Revenue Management System (ARMS), AIL acquired and implemented an ARMS – PROS 5.2, supplied by PROS (a leading vendor of revenue management systems) – in June 2001. PROS 5.2 was used upto 2007, but fell into disuse when server failure resulted in loss of two years data, and was only marginally utilised after revival until May 2010. PROS was upgraded to PROS 5.12 in February/ April 2010. AIL has been able to use PROS in auto pilot mode only in a limited number of sectors and in lean season, and had to result to manual intervention in respect of the majority of sectors. Besides software limitations, one of the reasons was that the sole surviving IT server (out of the original seven servers) was running in excess of 85 per cent of capacity with very poor response time to end-users.

The use of PROS was again discontinued from February 2011, after the introduction of the new single code reservation system, which required integration of PROS with the new reservation system. The use of PROS was restored for international flights only from June 2011; for domestic flights, the use of ARMS has not yet been implemented, due to lack of adequate training of the revenue management team at Delhi.

Management is actively considering a proposal for a 4th generation ARMS – PROS O&D, which can forecast demand at O&D level (instead of at sector level), thereby looking at maximising overall network revenue. This was approved by the NACIL Board in August 2010, but has not yet been implemented. However, even this tool does not represent a state-of-the art ARMS, which will take into account automated real-time pricing models and analytical tools. This cannot be over-emphasised in the current dynamic and competitive environment.

The Ministry noted (August 2011) the audit observation.

6.4 Productivity Linked Incentive (PLI)

IAL's PLI scheme for pilots, introduced in 1993, was extended to other categories of employees between May 1994 and March 1998.

In the CAG's Audit Report – Union Government (Commercial) of 2004, we had pointed out that the pre-determined performance levels (for disbursement of PLI) were less than the average performance achieved by the workmen prior to introduction of the PLI scheme. Pegging the base level for incentive payment below the average performance level amounted to rewarding the employees for less-than-average achievement. Deficiencies in the PLI scheme (revised in February 2005) were again highlighted in the CAG's Audit Report – Union Government (Commercial) of 2008.

A comparison of the profit/ loss of IAL, the overall load factor and PLI during 2004-10 revealed that an increasing trend in losses and static/ decreasing Overall Load Factor was contrasted by enormous increases in PLI.

Table 6.12 – Profit/ (Loss) and PLI of IAL/ NACIL (narrow body)

Year	Profit/Loss (Rs. in crore)	Overall load factor (%)	Total PLI (Rs. in crore)
2004-05	66	69.1	438
2005-06	50	71.6	473
2006-07	-240	73.1	534
2007-08	-1124	70.9	679
2008-09	-2962	63.0	685
2009-10	-2774	66.4	750

AIL had a separate PLI structure – introduced in May 1996 for technical cadre employees and subsequently extended for other employees. As in the case of IAL, the base performance levels for PLI payment were set well below the average performance prior to introduction of PLI, as summarised below:

Table 6.13 – Average Performance Prior to PLI and Base Performance Level for Payment of PLI in respect of AIL/ NACIL (wide body)

Parameter	Base Performance Level for Payment under PLI	Performance Level for 100% PLI Payment	Average Performance Prior to PLI
On time performance	56%	80%	66%
Revenue per Available Tonne Kilometre (in Rs.)	10.93	11.69	11.17

Parameter	Base Performance Level for Payment under PLI	Performance Level for 100% PLI Payment	Average Performance Prior to PLI
Passenger carried per Employee (in numbers)	22.90	26.40	24.13
Equipment Serviceability	84.25%	89.50%	87.28%
Dispatch Reliability	96.01%	97.5%	96.63%
Aircraft Availability	65.47%	78.84%	73.36%

Although an internal committee of AIL (constituted in August 2008 to work out modalities for implementation of reduction of PLI/ Allowance) had recommended (September 2009) reduction ranging from 25 to 50 per cent (yielding Rs. 600 crore annually), this was yet to be implemented. PLI continued to be paid, irrespective of the poor financial performance of the AI.

In response (February 2011):

- The Management stated that when revision of pay scales effective January 1997 was being considered, it was assessed that any modification to existing PLI schemes may result in industrial unrest. Further, AI had already taken steps by carrying out an extensive examination to link PLI and perks with productivity and align them with work performance, as also to evolve Key Performance indicators (KPI) and Balanced Score Card approach for assessing the performance and accountability of individuals to decide upon incentives and bonus.
- The Ministry referred to the legacy union agreements as an important factor standing in the way of any meaningful rationalisation of cost and service related matters. The lack of rationalisation and resultant non-harmonisation of wage related issues had a negative bearing on the efficiency and productivity of the airline as a whole. These facts were submitted before the CCEA, which directed that AI may be advised to carry out an exercise for wage rationalisation. Accordingly, Air India was instructed to initiate action for wage rationalisation in consultation with various unions/associations.

The fact remains that huge amounts are being paid as PLI to different categories of staff without appropriate linkage to operational and financial performance, at a time when the entity can ill afford such payments.

While the liberalised approach to bilaterals, as well as external factors (ATF prices, and economic recession from late 2008 onwards) were important contributory factors leading to the dismal financial and operational performance of IAL/ AIL and the merged entity, chronic operational deficiencies in their functioning cannot be ignored.

The Ministry accepted the audit comment and stated (August 2011) that action would be taken by AI, based on the recommendations given by the Justice Dharmadhikari Committee.

6.5 Turn Around Plan(s)

From August 2009 onwards, multiple versions of a Turn Around Plan have been presented:

Table 6.14 – Details of Turn Around Plan(s)

Turn Around Plan (August 2009)	Presented to CoS, and included cost reduction and revenue enhancement targets: • Fuel savings of Rs. 124 crore during 2009-10; • Staff cost reduction from Rs. 839 crore/ quarter to Rs. 650 crore/ quarter in 2009-10 (3rd quarter); • Reduction in material and maintenance cost by Rs. 234 crore, Rs. 508 crore and Rs. 683 crore in 2009-10, 2010-11 and 2011-12 respectively; and • Revenue enhancement from Rs. 2,077 crore in 2009-10 2nd quarter to Rs. 2465 crore by 4th quarter. GoM laid down milestones in November 2009/ February 2010. MoCA released Rs. 800 crore as equity infusion in March 2010 on the grounds that the company had attained certain milestones, and also provided an outlay of Rs. 1,200 crore in the 2010-11 as equity contribution, concomitant on achievement of targets.
Revised Turn Around Plan (July 2010)	Approved by AIL Board with the following salient features: • Targeted net profit (before depreciation, interest and tax) of Rs. 21,200 crore during 2010-15; • GoI equity infusion of Rs. 8,000 crore + GoI guarantee for working capital borrowings + all-inclusive interest rate not exceeding 9 per cent; • Estimated fleet size of 235 to 270 aircraft for different types of operations; and • Separating ground handling and MRO operations from the main airline business. Government Director's concern regarding lack of plans for rationalisation of wages/ PLI cost was not accepted, as the AIL Board felt

	that wage/ PLI cuts as a "front-end strategy" would be a negative factor in seeking the assistance of the unions.
Review of Turn Around Plan (February 2011)	Deloitte had furnished a report on "Review of Turn Around Plan" in February 2011, after considering four financial scenarios proposed by AI. Some of the salient projections/ assumptions underlying the review report are as follows: • Increase in AI's domestic market share from 17% to 21% (with PLF of 75% and 80% in full service and LCC operations respectively), assuming a growth in domestic market of 22% p.a. (against the overall market growth rate of 12-13%). • Growth of AI's market share by 15% p.a. (against market growth of 8-9%), with targeted PLFs of 71 to 80%. • Yields from wide-body aircraft growing at 5% p.a. to stabilise at Rs. 3.55/RPKM and from narrow-body aircraft at 3% p.a. to stabilise at Rs. 4-5.55/RPKM • Staff cost to decrease from Rs. 0.92/ASKM in 2010-11 and Rs. 0.32/ ASKM in 2014-15.

The Deloitte Review Report is predicated on extremely challenging assumptions. Essentially, AI's efficiency (commercial, operations etc.) would need to make quantum jumps in 4/5 years (much faster than their competitors). Further, the impact of staff costs is sought to be reduced by "spreading" them over a substantially expanded fleet of 235 to 270 aircraft.

In our view, further expansion of aircraft fleet (whether through leasing or acquisition) is an extremely risky proposition, considering that the financial burden of even the 2005 aircraft acquisitions will continue to be borne for several years to come and the current financial position of AI is extremely precarious.

The Ministry noted the audit comment and stated (August 2011) that the same would be taken note of by the Committee for Turnaround Plan appointed by the GoM.

During the Exit conference (August 2011), the Ministry stated that the Turn Around Plan was under process and would be submitted to CCEA. The Plan inter-alia included various options, viz.

- 10 year plan to meet the gap between revenue and expenditure,
- Financial restructuring of loans,
- Infusing government equity,
- Payment for VVIP flights,
- Induct Independent Directors on the Board of AI,
- Shelve out MRO and Cargo Handling, etc.