Indian Air Carriers and Foreign Investment

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Aviation is an important part of national infrastructure and one of the prime movers for economic growth and an important strategic element of employment generation.

Adoption of global standards has made aviation a safer way to travel. Forecasts by AAI for the next 5 years have projected a sustainable growth rate of 16% for international and 20% for domestic aviation sector. Recognizing the exponential growth of air traffic in India, the Ministry of Civil Aviation has been following a very liberal policy in the exchange of capacity entitlements / traffic rights. Domestic airlines have been allowed to fly overseas, forge partnerships with foreign carriers while foreign carriers in turn have been interlining with domestic airlines to access secondary destinations.

**Aviation Sector**

The aviation sector has always been a unique sector in the view of the government. The core characteristics that distinguish civil aviation from other industries now include:

* Dominant state ownership, and a higher degree of immunity from competition policy, partly on the grounds of national security and pride;
* Pervasive controls on entry, capacity, and tariffs, on the grounds of the size of investment needed and the presence of network externalities;
* Existence of an international regime with specific international organizations and institutions;
* High degree of vertical integration, with *de jure* or *de facto* control and ownership links between physical infrastructure and air and ground services.

Due to the above situation, this sector was kept under extreme govt. control for a long time until the mid 2000’s, when the market was de-regularised. By 2008, the market had expanded to cater for 11 carriers in the domestic markets. A lot of Indian careers have been approached consistently for tie ups with international airlines. However the DGCA regulations categorically forbid “foreign airlines” to participate directly or indirectly in the equity of an Air Transport Undertaking engaged in operating Scheduled, Non-Scheduled, and Chartered airlines.

**Foreign Direct Investment**

Foreign investment involves two components; namely portfolio investments and foreign direct investment (FDI). Portfolio investments refer to stocks, bonds and other privately and publicly held securities[[1]](#footnote-2) while FDI refers to investments in real estate and industry[[2]](#footnote-3) (that means investment in the facilities that produce or market products) [[3]](#footnote-4). Although no uniform definition of FDI exists the one given by the International Monetary Fund (IMF) is gaining wide acceptance. According to the IMF, FDI can be defined as an: ·"Investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investor’s purpose being to have an effective voice in the management of the enterprise.[[4]](#footnote-5)

FDI can take the form of strategic alliances such as joint ventures and franchising agreements or mergers with and acquisitions of foreign entities.[[5]](#footnote-6) The advantage of FDI is that the new entrant becomes known in the host State in a relatively short time. [[6]](#footnote-7)

FDI must also be distinguished from pure foreign investment. The difference between the two is that in a ·"direct" investment the investors require some form of control over the running of the invested company. This explains why FDI is more scrutinized than pure foreign investment. The regulatory restrictions are, as this submission will show, quite strict when sensitive industries like telecommunications and airlines are involved.[[7]](#footnote-8)

**Aviation Sector – Need for regulation?**

The International Civil Aviation Organisaiton (ICAO) is the organization which regulates international civil aviation. Established in 1944, ICAO was charged with safety and security as well as the operational issues of civil aviation.

The International Air Transport Agreement played an important role in shaping the restrictions on foreign ownership and control even though the Agreement never entered into force. Section 6 of the Agreement reads:

Each Contracting State reserves the right to withhold or revoke a certificate of permit to an air transport enterprise of another state in any case where it is not satisfied that *substantial ownership and effective control* are vested in nationals of a contracting state...[[8]](#footnote-9)

The rationale for this section is to be understood against the background of the Second World War. States were afraid that former enemies might take control of an airline flying into its territory and thereby jeopardize its national security. Even though the Agreement failed to come into effect, Section 6 later became part of most bilateral agreements.[[9]](#footnote-10) Therefore, in most of these bilateral agreements, the Transport Agreement's Section 6 has been inserted as a special clause. This has effectively meant that FDI in an airline of another country had to be limited to such levels that effectively prevent other States from acquiring ownership and control.

**Reasons for Restriction**

The bilateral agreements which grew out of the principle of national sovereignty over airspace which forms the basis of Chicago Convention had two consequences: one was that airlines had nationalities and that governments were given a central role in negotiating route rights; the other was a series of national laws limiting foreign ownership or control of carriers.

In fact, Article 77 of the Convention expressly permits operations involving joint or coordinated efforts among airlines to provide international service. There is, however, wording in the model forms arising from Chicago, notably in Article 6 of the Chicago standard bilateral form that permitted either party "to withhold or revoke a certificate or permit to an airline where it is not satisfied that substantial ownership and effective control are vested in nationals of either party to this agreement ..."

**Path to Liberalisation**

There are different paths to reform in such a complex regulatory environment. One option is to focus on the liberalization of capacity controls, which is equivalent to removing restrictions on designated airlines on supplying services from their home base. Another is to concentrate on removing the restrictions on ownership, which is equivalent to liberalizing the conditions for designation, and permitting higher levels of foreign ownership.

The Indian sector has seen the emergence of new low-fare airlines, which have become an important source of pressure for change and adjustment among the established operators. Their potential contribution will be reinforced if it were possible to promote foreign participation in ownership and management and by loosening the ties on the design of their networks. Without commitments to adjust their own pricing and service packages and to cut their costs many traditional full service operators will face a rapidly deteriorating financial situation.

While foreign direct investment (FDI) would probably provide the managerial and technical skills needed to improve factor utilization, particularly in developing economy like India, extensive cross-border activities in this industry are combined with almost insurmountable obstacles to foreign direct investment.

**Reasons for not allowing FDI in India**

1. **National Security**

In the early days, the Civil aviation fleet was kept as a reserve fleet to support the air force of a country if need be.[[10]](#footnote-11) At that time it was reasonable to fear that an old enemy could take over a new airline and use its aircraft directly against the country since aircrafts were easy to convert into warplanes.[[11]](#footnote-12) Today with its huge fleet of military transport aircraft and purpose built bombers, the US Government or any other state is unlikely to utilize the civil aviation to a large extent.

Another fear is that the foreign owners unsympathetic towards the home country could withdraw their planes in crisis times[[12]](#footnote-13). This fear appears overstated. First of all the call on aircraft are based on registration in the US or the country concerned and not on the nationality of the airline[[13]](#footnote-14). Withdrawing them from use would be illegal. Furthermore, crews whose loyalties are questioned can easily be replaced.

1. **Financial Security**

Due to the high start-up costs and competition from subsidized foreign airlines, Indian carriers needed financial protection in order for the industry to mature and become internationally competitive (The "infant industry”- argument).

The danger of the infant industry argument is that such protection must end when the industry has matured. If not it will lead to inefficiency in the operation of airlines. However, it is not always easy to tell when this has happened.

1. **Cabotage**

Even though cabotage is currently not allowed under the Air Corporations Act, 1953*,* it would seem to be possible were there no restrictions of foreign ownership. Where a foreign airline owns or controls a domestic airline it could in fact run cabotage operations. In this way it would gain access to the Indian domestic market and circumvent the *Act.* Total ownership of an airline is not necessary for this to happen. It can be argued that even if the *Act 's* prohibition was relaxed to the said *49%* effective control of the airline would be almost impossible to prevent. Even with the current 25% limitation it is sometimes hard for the DOT to determine who has actual control.

Second and more important, is that if India did allow unrestricted foreign ownership in their airlines without receiving similar freedoms, other States would simply have no incentive to negotiate liberal bilateral agreements with the us. By investing and even fully owning an Indian carrier, all the freedoms of the air would be available to the foreign states and its entities. There would therefore be nothing left to negotiate. Since the govt. would have given away all its traffic rights by allowing FDI in return it would have received nothing.

**AVIATION SECTOR IN INDIA**

The Aviation Sector in India has seen its ups and downs. From posting profits to the tune of US$ 730 million, Air India suffered losses of US$ 2 Billion from the year 1995-1999. This was primarily due to

* Contract Labour (Regulation and Abolition) Act 1970 and the Industrial Disputes Act 1947 prevented the company from outsouring its non-core activities and reducing workforce per aircraft
* Air India and Indian Airlines (the state-owned domestic carrier) are obliged to buy aviation turbine fuel from the government at prices that are a third higher than the international norm, and to pay a special tax on the same
* annual Haj pilgrimage flights and the use of two Air India planes (one aircraft is kept as a stand-by) for the Prime Minister’s visits abroad are never compensated on commercial terms.

Although In 1996-1998, Tata and SIA tried to launch a domestic carrier, but the civil aviation minister had publicly stated his opposition on numerous occasions (Airline Business 1998). Without a competitor, the airline kept posting losses every financial year, thus prompting the govt. to consider privatization of the Maharaja. According to the terms of the policy announced in May 2000 to offload 60 percent of capital, a local strategic investor was being sought for a 40 percent stake, with the remaining 20 percent earmarked to retail investors and employees. The strategic investor might form a joint venture with a foreign airline but the latter would only be allowed to own a maximum of 26 percent of Air India.

Although many Asian and European carriers were expected to make bids, only two bids were presented in May 2001, by the Tata Group with SIA and by Ashok Leyland, backed by the Hinduja brothers. The latter, however, was soon disqualified on the grounds of national security. As this left only one party bidding for the same, the govt. cancelled the plan owing to heavy opposition from the Congress.

**Need for Investment**

Despite recent improvements in load factors, most of the world's airlines, suffering from overcapacity and increased competition, still have severe economic problems.

These economic difficulties have coincided with the airlines' major needs for fleet replacement. A 1992 ICAO study indicated that from 1991 to 2010, the world's airlines will have to spend more than $800 billion on new aircraft, a figure double that of the previous 20 year period. But given world economic conditions and difficulties in attracting capital, actual purchases may fall far short of this projection. Add to that, mounting losses of the airlines, rising aviation fuel prices, congestion at airports, shortage of qualified pilots and technical manpower, higher costs of security, land acquisition, high taxation, high airport charges etc and we have a cocktail of bankrupt airlines.

India’s largest private air carrier Jet Airways last Friday posted a net loss of Rs 713.6 crore for this year’s September ended quarter, against Rs 12.4 crore in the year-ago period. Second-largest carrier, Kingfisher Airlines, reported a net loss of Rs 469 crore ($93 million) for the quarter ended 30 September — double of the Rs 231 crore loss it recorded in the year-ago period.

**Areas of Growth**

1. **Bilateral Agreements**

India has so far entered into Air Services Agreements with around 101 countries. During past five years as a result of open skies with USA, near open skies with UK/ASEAN/SAARC along with liberal bilateral agreements with other countries there has been huge increase in entitlements/new routes for foreign airlines. Recognizing the exponential growth in air traffic in India, the Ministry of Civil Aviation has been following a very open-minded policy in exchange of capacity entitlements / traffic rights. Domestic airlines have been allowed to fly overseas, forge partnerships with foreign carriers while foreign carriers in turn have been interlining with domestic airlines to assess secondary destinations. In addition, the government has also tried to ensure a conducive environment for the growth of all stakeholders associated with Indian aviation segment.

1. **Non Scheduled Services**

Non scheduled services are services which are not operated on a published time table and possibly be on charter basis. The operator of non scheduled services is not permitted to publish time schedule and issue tickets to passengers. Such services are used mainly for air charter, joy charter, tour operations, corporate charter, air ambulance, cargo charters, corporate charters, aerial photography, geographical surveys, and relief and rescue operations**.**

Today’s businessmen understand better than anyone else that time is money. CEOs and other senior executives want to achieve more in their full-up schedules. This is indeed why more and more companies and individuals are realizing the cost and timesaving benefits of using private jets and helicopters.

1. **Open Skies in Cargo**

A policy of “open skies” for air cargo was adopted in 1990, initially for a three-year period, and extended in 1992 on a permanent basis (Aeronautical Information Circular AIQ No. 18/1992). Under this new policy, any airlines, whether Indian or foreign carriers which meet specified operational and safety requirements, are allowed to operate scheduled and non-scheduled cargo services to/from any airports in India where custom/immigration facilities are available. These new policies were consolidated into a package together with further liberalization on domestic air taxi operations and relaxation of the rules on international tourist charters, and were implemented on a unilateral basis without requiring comparable rights for Indian carriers from bilateral partners in return.

Needless to say, the open skies in Cargo, led to an increase in traffic over the Indian subcontinent, which further saw competition in the sector. This competition was the reason behind the cost efficiency of Air India, which looked at making changes in order to compete with international airlines such as KLM and Air France, which turned out to be huge players in the international cargo sector. With an open skies agreement in place, the share of Air India in the cargo sector consistently declined, hence proving that the few no. of passengers that Air India had in the sector were only due to the market regulation and nothing else

**Current FDI Status in Indian Aviation**

The government allows for 100% FDI in Greenfield projects, Maintenance and Repair overhauls, Flying Schools and technical training. Furthermore, in existing projects the government allows for 100% but with prior approval of the government in case the FDI is supposed to exceed the mandated 74% FDI through the automatic route. Same is the case with ground handling services in which also there is only 74% FDI allowed, but 100% is allowed in case of OCB’s under the automatic route. All of the above are subject to any sectoral regulation that the government might implement in from time to time.

With regards to Air transport services, Scheduled Air Transport Service / Domestic Scheduled Passenger Airline allows for FDI up to 49% and investment by Non-resident Indians (NRI)/ OCB’s up to 100% allowed under the automatic route. Non-Scheduled Air Transport Service/ Non-Scheduled airlines, Chartered airlines, and Cargo airlines can have FDI up to 74% and investment by Non-resident Indians (NRI)/OCB’s up to 100% allowed under the automatic route. Helicopter services/seaplane services requiring DGCA approval- FDI up to 100% allowed under the automatic route. No foreign airlines would be allowed to participate directly or indirectly in the equity of an Air Transport Undertaking engaged in operating Scheduled, Non-Scheduled, and Chartered airlines. Foreign airlines are allowed to participate in the equity of companies operating cargo airlines, helicopter and seaplane services.

The cap on FDI by foreign airlines in the Indian airline industry was intended to protect the interests of Indian Airlines at a time when Singapore Airlines was seeking to enter the domestic aviation sector through a joint venture with the Tata Group. Today, the Indian airline industry is badly in need of capital. Only foreign airlines have the expertise and experience required to make an investment in the domestic airline industry worthwhile. It's time to remove the regulatory constraints on FDI by foreign airlines.

**Need for Immediate Action**

FDI in the Indian sector is one of the very few ways of controlling the spiraling losses of Indian carries. Above all of this, time is of the essence. As our airlines mount more and more losses every day, it will get difficult to find takers to invest in such huge loss making business. In today’s difficult environment, generally speaking, many airlines are trying to keep their balance-sheets strong rather than investing in other airlines. Investing in loss-making business is obviously not a winning strategy.

However, for efficient use of the influx of money that comes from FDI, it is important to see that there is scope for those investing money in the sector to get a good return. For that, we need to slash the taxes on ATF, which are the “main problem” having “a significant drag” on Indian carriers. It handicaps the whole industry. It pushes costs up. So fares have to be increased to break even. Then you will have less traffic and less revenue. It is a horrible spiral of cost. It is penalising the industry. Globally, even in the bad days, fuel costs do not account for more than 30 per cent of the total costs of airlines (the world over). But in India, it is 45 per cent. Till the time, this sector has such high taxes in order to reduce the cost of other kerosene related products, there is no scope for a reduction in prices in order to reverse the cycle of losses.

Another issue is the limit to the FDI. While the government is working on getting a 26% limit approved for investment by foreign firms, Indian players in the sector have gone on record stating that such an basic investment is not an incentive enough for the international players to invest in the Indian sector. At 26%, in spite of the money put in, they do not have the say that they would like to have and hence they would stay away from active involvement in the Indian sector. Therefore on January 3, 2012 the Working Group on Civil Aviation (WGCA) comprising secretaries of various ministries has already proposed raising the foreign direct investment (FDI) limit to 49 per cent.

A 49 per cent stake sale would be [far more attractive to foreign carriers than 26 per cent](http://businesstoday.intoday.in/story/aviation-ministry-airlines-fdi/1/20799.html). It is felt that the Indian aviation sector [is going through a very great depression and that the FDI limit](http://businesstoday.intoday.in/story/fdi-in-aviation-not-a-solution-for-debt-ridden-sector/1/20671.html) needed to be increased to 49 per cent in order to bring in much-needed large investments, said a top government official.

At 46%, the investor gets voting right allowing stockholders to vote on matters of corporate policy and composition of the board of directors. Voting often involves decisions on issuing securities, initiating corporate actions and making substantial changes in the corporation's operations. Currently, FDI up to 49 per cent is permissible in the aviation sector. But foreign airlines are not permitted to invest in domestic airline companies.

The ministry of civil aviation has in principle agreed to the hike in FDI limit to 49 per cent, but whether the same will be approved or not is something of a doubt.

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2. Ondrich and M. Wasylenko. *Foreign Direct Investment in the United States: Issues•.Magnitudes and Location Choices of New manufacturing Plants* (Michigan: W.E. Uplohn Institute for Employment Research. (993) at213. [↑](#footnote-ref-3)
3. C. Hill. *International Business: Competing in the Global market Place.* 2d ed. (London: Times Mirror Higher Education Group Inc. 1997) at 176. [↑](#footnote-ref-4)
4. International Monetary Fund, *Balance of Payments Manual ·108.* 4th ed. (New York: International Monetary Fund, 1977) at 136. [↑](#footnote-ref-5)
5. Y. Kurisaki, *Globalisation or Regionalisation: An Observation of Current PTO Activities* (1993) 17: 12 Telecommunications Policy at 701. [↑](#footnote-ref-6)
6. Y. Kurisaki, *Globalisation or Regionalisation: An Observation of Current PTO Activities* (1993) 17: 12 Telecommunications Policy at 701. [↑](#footnote-ref-7)
7. G.M.F. Kaa, *Foreign Equity Participation in United States Airline* (Montreal: McGilI University. 1989) at 10. [↑](#footnote-ref-8)
8. S.6, *International Air Transport Agreement,*Dec. 7. [944. U.S. Dept. of State Publication] 2282. [↑](#footnote-ref-9)
9. T.L. Masson-Zwaan & P.M.G. Mendes de Leon. Eds., *Air and Space Law: De Lege Ferenda.* (De Hage: Kluwer academie Publisher. 1992) at 27 [↑](#footnote-ref-10)
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11. S.M. Warner. *Liberalize Open Skies: Foreign Investment and Cabotage Restrictions Keep .Non-citizens in Second Class.* (1993) 43 Am. U. L. Rev. 305. [↑](#footnote-ref-12)
12. S.K. Skinner. Secretary of Transportation (Address to International Aviation Club. September 19. 1989) in Donner Brown. *Supra* note 30 at 1272. note 23. [↑](#footnote-ref-13)
13. *Leveraged Buyouts and Foreign Ownership of United States-Airlines: Hearings on H.R. 3-1-13 Before the Subcomm. On Aviation of the House Comm. On Public Works and Transportation.* 101st Cong., 1st Sess. 8 ( 1989) at 114. [↑](#footnote-ref-14)