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Draft aviation policy wants middle-class to fly more

Slew of measures announced but more clarity awaited

On October 30, 2015, the Government of India unveiled the much-awaited draft civil aviation policy, offering a bouquet of measures to make air travel more affordable to the masses. The key propositions include a capped price system to boost regional connectivity and service tax waiver for maintenance, repair and overhaul (MRO) companies. On the flipside, it lacks clarity on the government's position on the 5/20 rule. The policy also does not dwell on the long-pending structural issue of high sales tax on aviation turbine fuel (ATF), which diminishes the attractiveness of the sector. The government has sought feedback from various stakeholders before the final policy is released.

Thrust on boosting regional connectivity in a price-capped system

The regional connectivity scheme (RCS), effective April 1, 2016, would be designed such that fares for a one-hour flight will be capped at Rs 2,500 - applicable only in states which reduce value-added tax on ATF at RCS airports to 1% or less. The government is not just aiming to revive un-served or under-served airports, but is also considering setting up no-frills airports at a cost not exceeding Rs 500 million each.

This scheme will be implemented via viability gap funding (VGF) for scheduled commuter airlines (aircraft capacity of less than or equal to 100 seats). Accordingly, airlines such as Air Costa, Air Pegasus, Turbo Megha, Jet Airways, SpiceJet, Air India, etc, would qualify for VGF. While the Ministry of Civil Aviation will provide viability gap funding on air tickets from 80% of the regional connectivity fund (RCF), the rest will come from the state. The RCF will be funded by charging 2% cess on air tickets on international and domestic routes excluding remote locations. The government is also offering a host of incentives (to operators) such as ATF drawn from RCS airports shall be exempt from excise duty (8% currently) for a period of 10 years.

CRISIL Research believes this move would cap the prices on regional routes, which is a negative for airline companies given the government intervention and price control. Besides, more details are awaited in terms of whether a fare of Rs 2,500 per hour will be capped even for a last-minute booking under RCS, identification of specific routes and associated regional impact, if any, and specific modalities and procedures to be adopted in administering this scheme, etc. The 2% levy proposed to be charged on air tickets for RCF and free regime to charge for ancillary services would marginally add to overall ticket cost. However, even factoring this upside, we expect domestic air fares to decline by 5-7% in 2015-16 owing to the steep decline in fuel prices and intense competition.

Government's position on 5/20 rule continues to lack clarity

In October 2004, the Union Cabinet stipulated that for Indian carriers to fly abroad, they must service domestic routes for 5 years and have a fleet of 20 aircraft. Even in the October 2015 draft of the policy, the Union civil aviation ministry has kept all options open on this count -- (i) the 5/20 rule to continue, (ii) the 5/20 rule to be scrapped completely and (iii) replace the 5/20 rule with a domestic flying credits system. Hence, the draft does not offer any incremental clarity on this front.

Lays out tax incentives for development of MRO in India - a positive move

To provide a fillip to the maintenance, repair and overhaul (MRO) industry in India, the government has proposed to abolish 12.36% service tax, exempt customs duty on aircraft maintenance tools, tax-free storage period of spare parts imported by MROs extended for three years and simplified procedure for custom clearance. MRO, ground handling, cargo and ATF at the airport would also be accorded the benefits of the 'infrastructure' sector.

If this results in MRO activity picking up, there will be some foreign exchange savings as currently 90% of the MRO work for Indian airlines is been carried out in Sri Lanka, Dubai and Hong Kong. The tax regime in India has been a key dampener for MRO activity in India. Abolition of these taxes may now encourage Indian airlines to get MRO work done domestically. Besides, with the fleet size of domestic carriers expected to grow over the long term, the local MRO industry becomes critical because maintenance expense constitutes 10-15% of the total operating cost of an airline. This would be a potential revenue boost for airport operators, while simultaneously reducing cost for airlines.

Process to fast track greenfield airports would be more vital; extension of open skies

For fast-tracking of brownfield airports, the need for environmental clearances is proposed to be exempted, which is a positive. However, any policy on upcoming greenfield airports would have been more vital as we expect about 80-85% of the upcoming investments in that area. Besides, the policy has also indicated that all future airports would be developed on a 30% hybrid-till model, which would regulate 30% non-aeronautical activities that is partly negative for airport operators.

Effective April 1, 2020, the government would open the skies for short-haul routes. If indeed this happens, there will be an increase in foreign direct investment in airlines from 49% at present to more than 50%. Open skies for short-haul destinations could potentially invite intense competition from Gulf carriers.

Silent on the long-pending structural issue of sales tax on ATF

Though the previous draft aviation policy in November 2014 emphasised rationalisation of sales tax on ATF, there is no mention of it in the latest draft. High sales tax on fuel in India is a key structural challenge that diminishes the attractiveness of the sector. In the context of the parliamentary logjam impacting the implementation of Goods and Services Tax, the draft policy has been silent on this critical issue.

ATF cost, which constitutes 40% of the operating cost of an airline, is an important determinant of operating margin. In India, sales tax on ATF (which varies from 4% to 30%) is an additional burden for domestic carriers. This tax structure makes ATF prices in India 30-35% higher than in most countries. Though domestic airlines were permitted to directly import ATF from February 2012, they are yet to do so for want of infrastructure (landing, warehousing and transportation facilities for fuel). Clarity on this structural aspect can significantly improve growth prospects in Indian aviation.

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