WILLIS ASIA PACIFIC AEROSPACE CONFERENCE
BANGKOK, THAILAND

Monday, 9th February 2004

The State of the Aviation Industry in Asia: Past, Present and Future

Richard Stirland
Director General, Association of Asia Pacific Airlines (AAPA)

Good morning, ladies and gentlemen.

I suppose that one approaches every speech with a degree of trepidation, but I confess that I contemplate this one with perhaps more hesitation than most. Firstly, because the topic is so vast, although I have only myself to blame for that; secondly because I face an audience of acute observers of the aviation market, but most of all this is perhaps the last speech I give before I retire.

Let me reassure you that, although this is something of a farewell, and the title of the speech makes reference to the past, I do not intend to embark on a series of boring reminiscences.

However, I have always believed that to understand the present and to predict the future, it is necessary to examine and remember what has gone before. Nowhere is this more true than in the world of aviation.

Aviation in Asia has an incredible history. Over the past forty years we have seen it grow from an insignificant element of world aviation to a dominant role. Forty years ago, Asia relied for many of its air services, even within the region, on carriers such as Pan American, Northwest and Air France, and TWA operated twice daily through Bangkok and Hong Kong on a round the world service. Airlines such as Thai International and MSA, the precursor of Singapore Air Lines, relied on the technical and managerial support of SAS and Qantas.

Let us also not forget that this was a region racked by wars and insurgency, not just in Vietnam but also in Malaysia, the Philippines and the north of Thailand. It was a time when the citizens of South Korea and Taiwan were not permitted by their government to travel overseas, when Japanese needed to apply for a passport for every single trip, and when most countries in Asia had no middle class, only a tiny elite and a mass of citizens with neither aspiration nor hope of travelling overseas. China of course was a totally closed society.

Naturally, at that time there were many other regions of the world in a similar state, outside of the U.S.A. and Europe. But when we look around the world today, in terms of aviation, none have made such great strides as the Asia Pacific region, and I will not bore you with the statistics on traffic growth, increases in fleet size or destinations served.

A very significant element of this dynamic growth, which is often overlooked, is that it has been accomplished very largely within the same basic regulatory framework which prevailed forty years ago and by the airlines which existed in embryonic form at that time: Thai International, Singapore Air Lines, Cathay Pacific, Japan Air Lines, Korean Air Lines, etc. New airlines have emerged, such as Asiana and EVA Air, and rights have been liberalised, as well as market access, but continuity is a striking feature of the expansion of air services, and a key to understanding the present and the future.

I believe that this continuity is both a reason for the success of Asia's airlines, and a product of it. Success and sustained profitability have ensured survival of the pioneers. Time does not permit me to explore the details of why Asia's airlines, unlike those in other parts of the world, have been almost consistently profitable, but essentially the airlines are a reflection of their economies, benefiting from economic growth, productivity, stability, the aspirations of an emerging middle class. One needs only to point to China and its airlines, and to Vietnam.

Growth and profitability have enabled Asia's airlines to remain mostly unchallenged as national carriers, and growth and profitability, plus an excellent product, have largely negated any great pressure for radical changes to the regulatory regime of bilateral air service agreements, or national ownership and control.

I do not wish to sound complacent, but I believe that this stability, this steady growth and the continued existence of a market place dominated by the existing major players in Asia, is here for much longer than most commentators predict.

During the past 10-15 years, we have seen great pressure from the United States for so-called "open skies" in this region, followed by the promotion of multilateral air service agreements. The open skies have in many cases been granted, by countries such as Thailand, Singapore and Malaysia, including extensive regional rights for U.S. carriers. The reality is that in practice we see fewer operations by U.S. carriers in this region than we ever did in the past, and the prediction of multilateral agreements sweeping Asia has simply not happened. The reason is that the economic fundamentals are not there. Asian carriers have demonstrated that they can not only survive but prosper regardless of regulatory changes and the growth of GDP in the region has enabled the airlines to expand both routes and fleets. Conversely, the travails of U.S. carriers in the domestic market has hobbled their services to Asia.

Open skies, as the U.S.A. understands it, does of course permit greater co-operation within alliances, but here again the rhetoric and the reality, at least in Asia, are very different to each other. Most Asian alliance members will tell you, in confidence, that their bottom line is scarcely affected by their partnership, and again this is a function of the relative economic strength of Asia and the burgeoning trade and tourism purely within the region, and the relative economic weakness of Europe and the U.S.A.

Moreover, recent events such as 11th September 2001, the Gulf War, SARS and the bankruptcy of carriers in the U.S.A., Canada and Latin America demonstrated clearly to the management of Asian airlines that in such crisis situations alliances count for very little, and each airline must safeguard its own future.

In brief, alliances only make sense if they are half way houses to full blooded mergers and takeovers, but there is absolutely no sign that either governments or public opinion in this part of the world are ready to permit the identity of their national carrier to be submerged in such groupings. Of course, in a logical world, Asian carriers should be taking over and revitalising bankrupt U.S. carriers, but such an idea would be anathema to both the U.S. unions and the xenophobic ideologues in the current U.S. Administration.

You may well say to me at this stage, but is not your complacency and predictions of continuity going to be turned upside down by the advent of low cost carriers?

The success of low cost airlines, initially in the United States and subsequently in Europe, is well known. Many factors have been identified as the key to their success, but close analysis reveals that it is not due to any changes in the economic or operating environment, or sociological trends, but simply to the ability to reduce unit costs to a level 30%-40% below those of the incumbent or "legacy" carriers, and consequently to quote lower fares than the latter and yet make a substantial profit.

This achievement has been greatly facilitated by the low productivity and high costs, closely related to salary levels and work practices, of the major carriers in Europe and the U.S.A.

The future of low cost, or no-frills carriers in Asia must of necessity depend on their ability not just to operate at a low cost, but at a cost differential to the incumbents, and a fare differential which is sufficiently great to attract enough traffic to compensate for other inevitable handicaps of operating a no-frills service.

Empirical evidence would suggest that, while not impossible, to achieve these differentials on a sustained basis is going to be extremely difficult. The evidence indicates that the similarities in operating environment between the U.S.A. and Europe are not present in Asia, and a no-frills carrier in this region faces some unique hurdles.

These hurdles can be broadly summarised under three categories: geographical, competitive and regulatory, but it is important to note that many of the obstacles to no-frills growth are interrelated and mutually dependent: e.g. aircraft payload/range, freight revenue, unit costs and competition, as will be explored.

In simple terms, while the vast majority of routes where no-frills carriers have achieved major success in the U.S. and Europe are one or two hour sectors in an uncomplicated domestic environment (including the E.U. Common Aviation Area), where the incumbent airlines are using similar equipment to NFC's, and where they are relying on basically the same sources of revenue, Asia does not have these characteristics.

Secondly, the incumbent carriers in Asia are profitable, have good staff productivity and low labour costs and already operate in a highly competitive environment, indeed one which is more competitive than either the U.S. or Europe, even after the advent of the NFC's.

Thirdly, most commentators have missed the point that in order to achieve critical mass by generating viable levels of revenue and acceptable unit costs, airlines must do one of two things: create traffic flows between a multiplicity of cities by routing traffic through a hub, including interline traffic, or operate in mass markets on a point to point basis, replying almost entirely on the indigenous population at either end of the route for traffic and revenue. Emirates and Singapore Airlines are examples of the first, Southwest and Ryanair examples of the second.

However, in the latter case the critical mass has been achieved by operating point to point from multiple bases (in the case of Ryanair, 9 in Europe) simply because no single city has sufficient origin/destination traffic to a sufficient number of other cities to create the necessary volume. There are multiple examples to prove this point.

From the international standpoint, the regulatory regime precludes a single carrier from originating services in multiple points in different countries. Thus, any international no-frills carrier in Asia will be limited to the mass markets which exist (or can be created) between its country of registration/ownership and other cities.

Moreover, the latter are in reality far fewer than appears the case at first glance, for two reasons. First, such markets are almost certainly limited to a 3-4 hour radius, by the nature of the equipment NFC's typically employ and by the fact that cost advantages of NFC's, related mostly to ground costs, rapidly diminish with range. Secondly, unlike the U.S. and Europe, many existing mass markets in Asia (e.g. Bangkok/Hong Kong, Singapore/Indonesia) rely to a great extent on traffic other than

O and D for their volume. Such traffic can only be tapped by hubbing, interlining and/or GDS sales, all of which the true NFC shuns.

When all these factors are drawn together, it is problematic to see a major low cost operation, profitable on a sustained basis, being established in Asia in the immediate future. Aircraft economics, the nature of the job market and existing competitive practices would appear to preclude the creation of any significant gap, comparable to that in the U.S.A. and Europe, between NFC's and incumbents in terms of costs and fares, while the latter enjoy many advantages in Asia not available to the incumbents in those continents.

No matter how liberal the traffic rights regime becomes in Asia in terms of capacity, frequency, designation or available points, the ownership and control rules are unlikely to be relaxed any time soon and thus replication of the kind of network established by Southwest, Ryanair or Easyjet is not just difficult, but impossible.

Nevertheless, Asian incumbents must constantly guard against deficiencies in aircraft and staff productivity, product and pricing, of the type which in the U.S.A. and Europe created opportunities for the low cost carriers to exploit.

In Asia, of one thing I am very confident: success in the future will reside with those airlines which retain and enhance those values which have made them so successful in the past.