

Executive Summary

1 Introduction

The HKIA is the most valuable and strategic infrastructure project that has ever been built in Hong Kong. Recent estimates have placed the contribution to Hong Kong's GDP of the aviation industry and other derived services, of which the new airport is an integral part, at about 10%. Any changes in its governance structure, decision-making process and operational features should therefore be undertaken with extreme care and be supported by detailed assessment. Although it is believed that the partial listing of the airport could achieve some of the objectives that have been stated by the government, such as raising revenue in the short term, it should be remembered that equity financing is typically more expensive than debt financing, and that the protection of public interest could be a complex matter after listing.

Investors, and particularly international fund managers, are looking for the intrinsic investment value of a stock, or the historical rate of return and future income stream. The profit of the AAHK in 2002/03 was equivalent to a less than 2% return on equity. Even though it is not uncommon for relatively low returns at this stage of airport development, as is typical with most long-term infrastructure developments of this magnitude, such a return would not be attractive to most investors at this time. Thus, the economic viability of the proposed listing poses some daunting problems for both the government and potential investors. It should also be noted that the current challenges with the listing of the Link REIT and the upcoming elections may pose additional political risk to the listing of the AAHK.

Looking ahead, Disneyland will commence operation in a few months, and it is likely

that more cities in mainland China will permit individual travel to Hong Kong in the coming years. These developments, together with the next phase of implementation of China's accession to the World Trade Organization and China's hosting of the Olympic Games in 2008, should ensure that the HKIA will achieve a much more profitable business profile by 2009, which may prove to be a better occasion for any possible public listing of the AAHK.

Other than the fact that correct timing will be vital for a successful listing, Articles 128, 129, and 130 of the Basic Law may also have a bearing on the legal basis for the public listing of the AAHK. These issues, although less relevant from an economic analysis standpoint, could easily sway the decision on privatization, particularly in view of the problems that have been encountered in the recent attempts to list the Link REIT and the increase in toll charges at the Eastern Harbour Tunnel.

In the following sections, we turn to the current issues that have been raised by the HKSAR Government in the form of a public consultation exercise. This is followed by a discussion of the case for the privatization of the AAHK, suggestions for some over-riding principles for AA NewCo, and recommendations for the continuous improvement of the AAHK should the privatization exercise be postponed or abandoned.

2 Responses to the Government's Consultation Document on the Partial Privatization of the Airport Authority

In this section, we attempt to provide responses to the Government's Consultation Document on the partial privatization of the AAHK based on some of the analyses

that have been provided in the previous chapters. An abbreviated list of the 21 questions that were raised in the document is provided in Appendix for reference.

- (i) We strongly support the notion that the government be given sufficient power to exercise various regulatory functions. To achieve this objective, it is very important for the government to clearly identify in the new Airport Authority Ordinance all of the data and information that is required to be supplied in detail by the AAHK for supervisory and regulatory purposes. Such information may include various financial accounts and operational information for the different types of business activities; reports of the justifications and methods that are used for the formulation of fee levels, cost of capital, asset and cost allocation; and other pertinent financial and operational information. There may also be a need to consider issues that are related to safety, noise, pollution, or traffic congestion around the airport in the regulatory framework.

- (ii) The government is seeking to ensure that it is empowered to appoint a minority number of additional members to the future board of AA NewCo. This is only necessary if the possibility of the government not being able to appoint even a minority of board members through its shareholding or control of AA NewCo at sometime in the future is considered. We consider such a scenario to be untenable at any time. The strategic and economic importance of the HKIA is such that it is prudent for the government to **always retain control of the majority of voting rights in AA NewCo**. Anything less may bring into question whether we are still faithful to the mission of continuing “the previous system of aviation management in Hong Kong” and ensuring that the government is

still “responsible for the management of our airports”.

A further concern that arises from the government’s proposal, and particularly from the way in which it is worded, is the future role of the government as a shareholder of AA NewCo. The proposal as stated may be taken to mean that the government would appoint a minority number of board members to specifically look after the public interest of Hong Kong. The other directors would only look after the commercial interest of AA NewCo, even though they may be nominated and voted in by the government, as would be the case immediately after the privatization of the AAHK or if the government retained control of the voting rights, as was suggested earlier. That would imply, by virtue of the minority board members who are appointed to represent the public interest, that the government’s involvement in the HKIA would be based on commercial considerations, rather than public interest.

- (iii) Given the strategic and possible national security importance of the airport, we suggest that if and when the management of the HKIA is privatized, at least half of the board members of AA NewCo should be **Permanent Residents who ordinarily reside in Hong Kong**, and that the Chairman should be a Hong Kong Permanent Resident with **Chinese nationality**, rather than a foreign national.
- (iv) We support the limiting of the voting rights by any single shareholder (including associates) other than the government to 10% **only if the government retains control of majority voting rights in AA NewCo.**

Otherwise, additional measures may be necessary to safeguard against the possible collusion of various shareholders in exercising their rights in decisions that may potentially be against the interest of Hong Kong.

(v) We support this in principle, but the term **“ordinarily resident” should be replaced by “permanently resident”**.

(vi) to (x) We support these proposals.

(xi) and (xii) In the context of the privatization of the AAHK, the choice between securing a better valuation at IPO by increasing airport charges versus keeping airport charges more competitive is indeed a difficult one. This problem actually reflects the difficulty that would be faced if the aim moves away from operating a strategic asset solely for the overall benefit of Hong Kong toward attempts to balance the public interest and minority economic interest in a privatized entity. On the one hand, it is difficult to find justifications to artificially diminish the investment of Hong Kong taxpayers in the AAHK in favour of subscribers to the shares of the AA NewCo listing, but on the other hand, raising the airport charges simply to achieve a better valuation of the AAHK share price for the IPO may have even more flaws.

To begin with, airport charges play an important role in the economics of the airport system, which in turn contributes to the growth and prosperity of Hong Kong. Many international air transport organizations, most

notably the International Civil Aviation Organization (ICAO) and the International Air Transport Association (IATA), have developed guidelines and principles on this subject, and it is our Centre's belief that adjusting airport charges for the purpose of achieving a better valuation for a privatization exercise would run against the spirit of these principles at the very least. The argument that there is no strong evidence to suggest that the level of airport charges would sway airlines in their choice of destination is exactly the type of monopolistic problem that the ICAO, and the IATA have attempted to address in their guidelines, and is something that users fear the most.

Although it is arguable as to whether there is definitive evidence for the elasticity of airport charges, it is clear that the raising of airport charges cannot contribute to an increase in the demand for related airport services, and that, if anything, higher charges may reduce such demand and thus adversely affect the overall economy of Hong Kong. If the airport charges for the HKIA were raised to support a higher valuation at the IPO exercise and the subsequently adverse effects of such a decision on the overall economic benefit for Hong Kong were realized, then we would end up in an even more difficult position than we are in now. Keeping the airport charges at the established high level would continue to lessen the overall economic benefits for Hong Kong, and backing down from the higher level of charges would present a moral hazard for the government as far as the minority shareholders are concerned, as they would have been enticed into subscribing for shares at the higher valuation by the artificially (by hindsight) introduced level of airport

charges in the first place. Hong Kong would be in a difficult position, and we would find ourselves in a losing situation for all.

Thus, it can be concluded that **the establishment of airport charges should not simply be driven by the desire of the government to obtain a better valuation of its shares.** Airport charges should be reasonable (with a cost-based reference) and broadly competitive with comparable airports. In establishing airport charges, it is important to understand how charges may affect the overall Hong Kong economy (current evidence indicates that the aviation sector represents 10% of Hong Kong's GDP), and to appreciate that there are widely recognized and accepted practices in the establishment of airport charges that Hong Kong should refer to if there is deemed to be good reason to alter the current established practices of setting airport charges or the current level of charges.

The issue of airport charges when placed in the context of an airport authority that is entirely owned by the Hong Kong government solely for the overall benefit of Hong Kong is rather different, and is an internal valuation matter. The substantial amount of economic externalities and social benefits to Hong Kong should be viewed within the overall context of the Hong Kong economy in its entirety, instead of concentrating on a group of potential minority shareholders in a privatized company. The valuation of all such externalities, which would possibly include the contribution of the rather valuable land that was left vacant after the closure of the old Kai Tak airport, may even enter the

equation.

(xiii) **Until the trade-off between Hong Kong's overall economic interest and the economic interests of shareholders is settled** and the role of the Hong Kong government as a shareholder on behalf of Hong Kong taxpayers after the privatization exercise is made clear, **there is no simple answer to the issue of the user pays principle**. We are not opposed to the adoption of the **user pays principle** in general. However, it would have been a much superior proposition if this principle had been **made subordinate to the over-riding principle that the AAHK will operate for the overall benefit of the Hong Kong economy**. It is, of course, obvious that this latter discussion can only be considered if the AAHK is not privatized.

(xiv) There are pros and cons for both the single-till and dual-till approaches to the determination of airport charges, and we do not find overwhelming analysis or research evidence that can be used to support either one of the approaches in the case of the privatization of the AAHK. In general, there is a tendency for airport operators to prefer the dual-till approach, whereas major airport users, such as airlines, may prefer the single-till approach. It is also worth noting that the major international aviation bodies, such as the ICAO and the IATA, tend to support the single-till approach. A more important consideration here is that a **dual-till approach would be likely to lead to higher airport charges for the aeronautical side of the equation**. The issue of single till versus dual till also involves the fundamental issue of a trade-off between Hong Kong's

overall public interest versus the commercial interest of a privatized AAHK. Regardless of whether the guiding principles that underpin the proposed model of the consideration of airport charges are said to be single till, dual till, or otherwise, we consider the comparison of these approaches to be an area where the phrase “the devil is in the details” very much applies. Thus we have **no strong position on either of the approaches at the current level of proposal detail.**

- (xv) Should the government’s proposal in (xiv) be adopted, we would **support the consideration of a risk premium concept in the determination of the target return for aeronautical activities.** Nevertheless, the issue of risk premium should be examined carefully. On the one hand, core airport activities are natural monopolies, which means that they have little risk and should not demand any risk premium. On the other hand, as the recent experience of the September 11 incident and the SARS outbreak showed, aviation-related revenues can be reduced sharply overnight for a sustainable period of time. It is therefore important to ascertain how such downside risk should be assessed and factored into the consideration of the privatization exercise, and to establish whether users or the government as a representative of the wider interests of the entire community would be asked to assume some of the non-market risks. It is worth noting that in the US the federal government paid for a substantial amount of the additional insurance and security costs that were imposed upon the US airline industry after the September 11 terrorist attacks in 2001.

(xvi) The document proposes a bilateral negotiation mechanism between AA NewCo and airlines for airport charges within a set of broad parameters that are set out in the Ordinance. We expect **these broad parameters to include the setting and permission of a reasonable rate of return, the definition of a price-cap mechanism that is based on some kind of (CPI-X%) formula, and the establishment of high safety, service quality, and competitive positioning standards relative to airports that are comparable to the HKIA.** Recent research and practice give adequate support for the use of a price-cap model for application in Hong Kong. We support this “flexible” and “light-handed” arrangement over decisions that are dictated either directly by the government or from results that are derived strictly from a formula. However, we do encourage further detailed study and research into the application of such a price-cap model for adaptation to the Hong Kong case, as this may be a crucial piece of the puzzle that will anchor much of the economic regulatory considerations of AA NewCo.

(xvii) In the case in which both parties are unable to come to a final agreement in (xvi), the government has suggested that itself or a government-appointed panel should be empowered to adjudicate on the reasonable level of airport charges. **We are in support of the appointment of such an independent panel.** We would also like to suggest that the role of a relevant Legislative Council Panel should be studied, possibly along the lines of models for other similar bodies. A guiding principle in this process should be the transparency of the process and proper accountability to the public by the panel.

(xviii) to (xxi) We are in broad agreement with these proposed arrangements.

3 The Case for Partial Privatization of the Airport Authority

In the following sections, we provide our response to the reasons that the government has given for the privatization proposal (an abbreviated version of the stated reasons is provided in the underlined text at the beginning of each section).

3.1 Strengthen market discipline in the running of the airport for greater efficiency and more commercial opportunities.

Although stated as the main benefit of the proposed privatization, we suggest that less disruptive and more direct approaches should be explored to improve efficiency by the board and management of the AAHK before resorting to privatization. As the AAHK has always operated according to prudent commercial principles and the HKIA has been generally well managed, as stated in the justification for the privatization, the possible benefits of privatization for typical inefficient state enterprises are not applicable here for the most part. The same can be said for strengthening market discipline, although the specific targets of improvement need to be looked at in more detail, as the word ‘market discipline’ can encompass many concepts and issues. It is also conceivable that the good governance practices that are required by the Hong Kong Stock Exchange could be reviewed by the AAHK board for possible adoption without resorting to the actual listing of the Authority.

3.2 Enhance the AAHK’s access to the capital market.

There is no doubt that a listing on the Hong Kong Stock Exchange would provide additional avenues of access to the capital market. However, it should also be noted

that being a highly successful operation that is fully owned and backed up by the government of Hong Kong provides a more effective and efficient means of access to less expensive capital through the debt market or other means. A projection of the capital requirements of the AAHK in the short to medium term would be useful, along with an evaluation of various scenarios for the funding of those requirements with respect to the projected financial and operational position of the AAHK at that time. Given the high potential for improvement in the financial position of the AAHK in years to come, as stated in the opening section of this document, there is a strong likelihood that potentially superior alternatives will be available to satisfy future capital needs.

3.3 Introduce an additional quality stock to add diversity to the local financial markets.

Given that Hong Kong currently has over 890 companies listed on the Main Board alone with a market cap of over 6.5 trillion, the addition of AA NewCo would add little diversity to, or have any other appreciable effects on, the local market.

3.4 Offer an opportunity for Hong Kong people to participate in the success of a well-managed company with strong growth potential.

Conceptually and in reality (albeit indirectly), all of us in Hong Kong are owners of the AAHK and already participate its success and in the success of the HKIA. This applies to direct financial and commercial success, and, more importantly, the indirect effects that the success of the HKIA contributes to the overall economy of Hong Kong. Thus, this reason cannot be considered to be convincing justifications for the privatization exercise.

3.5 Proceeds from privatization will help strengthen government finance in the short to medium term.

Although it has been emphasized that it is not the foremost objective of the exercise in this case, this is often a major motivation behind many airport privatization exercises. This is also the most convincing support for some form of privatization for Hong Kong should the need to strengthen the government's finances in the short to medium term arise, and IPO could well be one of the good options. However, the original privatization proposal was floated when the Hong Kong economy was going through some testing times during the Asian financial crisis in 1998 and the subsequent global economic slowdown at the beginning of the new century. At that time, there was a need to re-balance the budget of Hong Kong and to seek out new sources of income for the government. Since then, we have moved on to much better times, most notably through the policy support that is provided by the Central Government in the form of the Closer Economic Partnership Agreement (CEPA) and the individual travel scheme for Hong Kong. The positive effects of these policies have been clearly witnessed in the past year, and are likely to provide a continuing impetus for the further growth of the Hong Kong economy in the near to medium term. Thus, at the very least, the short- to medium-term financial needs of the government have been significantly lessened, if not eliminated, for the time being.

In addition to the foregoing discussion of the five justifications, it is important that the concept of cost-benefit be brought into consideration. There are obviously costs that are involved in the privatization exercise, both in terms of monetary and other resources. The cost of continuing to maintain a listed company and continuously finding a balance between the public interest and the financial benefits of the minority shareholders in AA NewCo are significant costs that cannot be ignored. A glance at

the government's consultation paper indicates that many of the issues that are contained therein do not lend themselves to simple or easy solutions, and others are of the nature that if a less than optimal choice is selected, then the long-term repercussions would be tremendous in terms of the overall cost to the Hong Kong economy. This list of rather complicated issues is a clear reflection of the totality of the "costs" that are involved in the proposed exercise, not to mention the political and legal issues that may arise.

When we consider the cost considerations in the cost-benefit picture, together with the lack of strength in the justifications for the privatization exercise and the significantly diminished need for short- to medium-term props for the financial position of the government, we must conclude that the case for the partial privatization of the AAHK is not justified, either now or in the foreseeable future.

4 Guiding Principles for the Privatized AA NewCo

The HKIA represents a valuable and strategic infrastructural investment for Hong Kong. The mission of the HKIA, as stated in the Airport Authority Ordinance and again elaborated in Article 128 of the Basic Law, is to maintain the status of Hong Kong as the centre of international and regional aviation. Along these lines, it is important that any decisions concerning the HKIA or the AAHK, including those that are related to the proposed privatization exercise, demonstrate their contribution to the continuous improvement of the HKIA or the AAHK in accordance with this mission.

The current privatization proposal of the government and the subsequent decision on

the partial privatization of the AAHK is the most important decision that has arisen concerning the HKIA since its inception. In addition to the discussions and considerations of the various options that have been put forward in this privatization exercise, we would like to propose the following guiding principles as a key reference for analysis and decision-making should the decision to privatize be taken. More importantly, these should form the guiding principles for the standard of performance for AA NewCo to ensure that any decisions that are made are true to the mission.

- (i) AA NewCo will pursue continuous improvement toward the achievement of the established mission of the HKIA.**

- (ii) The overall service quality, and particularly the service quality of the aeronautical services, will not fall below the level of service quality level of the HKIA before privatization.**

- (iii) The overall level of charges (in relation to overall prices in Hong Kong and other relevant factors), and particularly the level of charges that are applicable to the aeronautical services, will not be higher than that before privatization.**

- (iv) The overall performance of the HKIA, as measured by relevant comparative studies, will not be worse than that before privatization.**

It is important to add that much more research will need to be conducted on the definition and establishment of a set of reliable and meaningful measurements of service quality, charges, and overall performance for the HKIA. Such work will be necessary irrespective of whether the proposed guiding principles are adopted.

Currently available models and methodologies in the literature may need to be refined, and a suitable and reliable methodology and set of measurements that are generally acceptable to the stakeholders of the HKIA will need to be devised.

5 In Pursuit of Continuous Improvement

Should the proposed partial privatization of the AAHK be postponed or shelved indefinitely, as our analysis advocates, we would like to suggest that many of the issues that have been discussed and the knowledge that has been gained in this privatization exercise be put to good use to improve the competitive positioning of the HKIA. This may include the following.

- (i) The adoption of improved governance and other practices that have been envisioned in the privatization exercise through a review of the practices that are required of listed companies, the engagement of consultants to assist in possible efficiency improvement, and attempts to build in systems that may achieve market discipline effects for the overall benefit of the organization.**

- (ii) Continuation of the projection of future capital needs, and evaluation and planning of the most cost-effective means to support the future funding needs of the development of the HKIA toward the established mission without it becoming a listed company.**

- (iii) Continuation of the study and implementation of appropriate regulatory frameworks and processes to ensure that the performance**

of the HKIA and the AAHK is on a continuous improvement curve. The devised frameworks should include the development and adaptation of reliable measurements of performance, improved mechanisms for the determination of airport charges and the adjudication of disputes, and a financial reward and penalty system that is linked to service standards.