IN THE MATTER OF A ROUTE LICENSING APPLICATION

UNDER THE AIR TRANSPORT (LICENSING OF AIR SERVICES) REGULATIONS (CAP.448A)

BEFORE THE AIR TRANSPORT LICENSING AUTHORITY

BETWEEN

CATHAY PACIFIC AIRWAYS LIMITED Applicant

and

HONG KONG DRAGON AIRLINES LIMITED Objector

D E C I S I O N

The application

1. On 7 August 2002 Cathay Pacific Airways Ltd ('Cathay Pacific') filed with the Air Transport Licensing Authority ('ATLA') an application for a licence to fly from Hong Kong to Shanghai/Beijing/Xiamen, and *vice versa*. The application, which was in statutory form, particularised the type of aircraft to be used, including both passenger and freighter, and further specified that the licence sought was for unlimited frequencies in each direction for a period of five years.

The objection

2. On 9 September 2002, within the statutorily-prescribed period after the gazetting of the application, Hong Kong Dragon Airlines Limited ('Dragonair') filed with ATLA formal objection to such application.

3. The narrative supporting the statement of objection submitted that the licensing of Cathay Pacific for the three China mainland points was not in the interest of the overall coordination and development of air services, that such entry into these routes would result in the "uneconomical overlapping of air services", and that entry of Cathay Pacific into the "lifeline markets" of Dragonair would threaten the survival of Dragonair, a result which would not be in the public interest.

4. The grounds of objection thus filed in September 2002 subsequently were supplemented with a challenge to ATLA's jurisdiction. Notice of amendment to the existing objection of 9 September 2002 was given by letter dated 22 January 2003 from Messrs Clyde & Co, solicitors then acting for Dragonair. The thrust of this amendment, which throughout this case has been referred to as 'the Basic Law point', was that the application in relation to the Shanghai and Xiamen routes was *ultra vires* the authority of ATLA to issue licences as delegated by the Central People's Government under Article 134(2) of the Basic Law.

The hearing

5. The public hearing of this application, and the objection thereto, took a total of eleven days, which possibly marks this inquiry as unique in the arcane world of aircraft licensing applications. Certainly,

this constituted the first contested application to take place before an ATLA panel for almost a decade. The unanticipated length of this dispute also resulted in the hearing itself spanning a period of three months; after the initial five days, from 23 January to 29 January 2003, the hearing was adjourned and recommenced on 11 March, the evidence being completed by the end of that week, on 14 March, and submissions thereafter taking place on 19 and 20 March 2003.

The protagonists

6. This is an unusual case, not least because the parties to this dispute share a substantial common history, and their relationship today continues to involve a substantial shareholding of the one in the other. Cathay Pacific/Swire currently hold 25.5% of Dragonair's equity — other major shareholders in Dragonair being China National Aviation Corporation and Citic Pacific — and such shareholding results in representation by Cathay Pacific on Dragonair's Board of Directors.

7. The historical development of Cathay Pacific and Dragonair is inextricably interlinked. Commencing in 1990, when Cathay Pacific bought a 35% interest in Dragonair, Cathay Pacific assumed control of Dragonair's management and strategic direction, and in the early years provided key management personnel on secondment. It is an ironic aspect of this case that, save for its retained professional consultant, the Dragonair witnesses before this tribunal were all ex-Cathay personnel, and as a result former close colleagues were pitted against each other in what at times became an emotionally-charged evidential clash. It is this element of the case that injected into this hearing an intensity level not generally

encountered in commercial disputes, the hearing at times bearing greater resemblance to a family altercation than to cool commercial appraisal of cost and consequence.

8. The historical evolution of Dragonair under the guidance of Cathay Pacific cannot, of course, be gainsaid. Nor was it sought to do so, although in the context of this inquiry only Dragonair attributed significance thereto. The purchase by Cathay Pacific of the 35% stake in Dragonair in April 1990 produced a restructuring of the Hong Kong airline industry; in addition to commercial and technical cooperation, in April 1990 Cathay Pacific also transferred its Beijing and Shanghai routes to Dragonair as part of a corporate strategy whereby a primary focus of Dragonair was to develop its mainland China routes. And having followed this course at the behest of Cathay Pacific, Dragonair now vociferously objects to that which it perceives as an unwarranted intrusion into an established domain, the pattern of which initially was established at Cathay's behest.

9. During the course of the hearing we were also referred, on occasion at some length, to the existing and past contractual arrangements between the two airlines — in particular the Management Services Agreement of 17 January 1990, relating to the provision of management services by Cathay Pacific to Dragonair, and its successor, the New Cooperation Agreement of 10 June 1996. The essence of this latter agreement, which remains in force, was to provide for a smooth transition from seconded Cathay Pacific management to a 'stand alone' management team for Dragonair, although there was to remain extant close cooperation and support "on a mutually beneficial basis" between the airlines. There

also has been much play made as to the fees — some HK$144 million to-date — generated by Cathay Pacific under these two agreements, although it strikes us that consideration of this aspect (like a good deal else in this case) is a matter best left to the confines of the boardroom.

10. We mention these matters at the outset because it seems to us important to state that in our view the relationship, whether historical or current, between Cathay Pacific and Dragonair is *not* a matter of significance given the particular function which this tribunal statutorily is required to perform, although we recognize that the history between these parties has tended to inflect the manner in which this dispute has been conducted.

The statutory mandate

11. We take this opportunity to reiterate that the task of an ATLA tribunal seized with a dispute of this nature is statutorily prescribed. ATLA is neither company doctor nor arbiter of profit level. It is an independent body, appointed by the Chief Executive, to resolve licensing disputes. Its 'operations manual' takes the form of the *Air Transport (Licensing of Air Services) Regulations*, Cap.448A, first promulgated on 4 November 1949, and thereafter periodically updated; in particular amendment has been made consequent upon the 1997 transfer of sovereignty and involves concomitant changes, in terms of "air services arrangements", to reflect the position as it now exists between the Government of the Hong Kong Special Administrative Region and that of the Central People's Government.

12. Section 5 of these Regulations permits the grant by ATLA of a licence "to carry passengers, mail or cargo by air for hire or reward on such scheduled journeys, and subject to such conditions, as may be specified in the licence". Detailed provision is made both for applications for, and objections to, the grant of licences, whilst ATLA is mandated to hold public or private inquiries in the event (as here) of due objection to any licence application. Most significant, however, is Regulation 11, the terms of which have remained unaltered since these Regulations were first promulgated more than a half-century ago.

13. Regulation 11, which appears under the heading "General Policy of Licensing Authority", condescends both to the general and to the specific. The carriage to this section reads as follows :

> "In exercising their discretion to grant, or to refuse, a licence and their discretion to attach conditions to any licence the Licensing Authority shall have regard **to the co-ordination and development of air services generally with the object of ensuring the most effective service to the public while avoiding uneconomical overlapping and generally to the interests of the public**, including those of persons requiring or likely to require facilities for air transport, as well as those of persons providing such facilities." (emphasis added)

Thereafter are listed eight matters to which the Licensing Authority is required to have particular regard. It is common ground in this case that only the first four as so specified are relevant in the circumstances of this case. These are :

> "(a) the existence of other air services in the area through which the proposed services are to be operated;
>
> (b) the demand for air transport in that area;

(c) the degree of efficiency and regularity of the air services, if any, already provided in that area, whether by the applicant or by other operators;

(d) the period for which such services have been operated by the applicant and by other operators; …"

14. In attempting to come to grips with the extraordinary amount and variety of evidence which has been presented to this tribunal during the hearing of this disputed application, we have taken care to ensure that our eyes have remained firmly fixed upon the statutory benchmarks. No consideration has been given to extrinsic considerations.

15. We venture to observe, further, that the discipline of viewing the case through the relevant statutory prism has been made the more necessary by the strikingly *ad hoc* manner in which the evidence has been presented to us. In addition to the formal written Submissions put in by each party before the hearing (the verbatim record of which comprises just under two thousand pages), the tribunal was subjected to a deluge of piecemeal data during its course, a good deal of which was designed to justify the statistical extrapolations variously advanced. It was only on the eighth day of this hearing that solid up to-date financial information, derivative from Dragonair's audited accounts for the year ending 31 December 2002, was made available to us, the information therein providing much needed focus and greatly facilitating the tribunal's task. Undoubtedly this was a difficult case, and we do not wish to criticize unduly. We express the hope that in future licence disputes the evidence adduced will be confined to those specific matters which ATLA statutorily is required to consider, and that such evidence will be submitted in a more reflective and considered manner.

The respective cases

16. We turn now to consider the broad nature of the cases respectively propounded. It seems to us necessary to identify the overrall shape of each case lest the welter of statistical and operational detail serves to obscure the central issues within this dispute.

(a) Cathay Pacific's case

17. The terms of the formal application notwithstanding — wherein the proposed scale of frequencies to the three mainland cities is specified as "unlimited … in each direction" — this case has been fought on the specific basis that the daily frequencies now sought by Cathay Pacific are 4/3/1 to Shanghai, Beijing and Xiamen respectively.

18. The type of aircraft said to be "primarily" intended for passenger service on these routes are A330-300 aircraft, a wide-bodied twin engine aircraft configured with 44 Business Class and 267 Economy Class seats, with a good cargo-carrying capacity; B777-200 or B777-300 aircraft are anticipated to be used in the alternative, but in any event all of the metal it is proposed to employ on these routes is designed and configured for the short to medium haul.

19. The proposed use of A330-300's mirrors that which also is operated by Dragonair on these routes, as supplemented by A320 and A321 utilisation, the latter being smaller single-aisle aircraft with limited cargo capacity. Dragonair currently flies to Shanghai, Beijing and Xiamen on a daily frequency basis of 8/6/2 respectively; the Xiamen route employs exclusively A320 aircraft, whilst the 42 weekly flights to Beijing are

equally divided between A330 and A321 aircraft, with the 56 weekly flights to Shanghai utilizing 42 A330 and 14 A321 aircraft.

20. When reduced to its fundamentals it is probably fair to say that Cathay Pacific mounted its application upon three distinct bases :

(i) first, the need for Cathay Pacific to be able to compete as a 'global airline', which it maintains cannot be the case if it does not even serve the major cities in the country in which it is based — it is here said that the absence of China operations spotlights a "glaring and obvious gap" in its network;

(ii) second, the desire to position Hong Kong as one of the world's leading aviation 'hubs', in order to enable Hong Kong, which continues to represent a natural gateway to China, to position itself at the heart of a burgeoning 21st century Chinese aviation market; and

(iii) third, the need for competition on these routes, in particular on the Shanghai and Beijing legs, and the consumer benefits which competition inevitably will bring in terms of choice and price.

21. Four witnesses spoke to Cathay Pacific's case, three of whom currently hold office within that company, namely Mr Anthony Tyler, Director of Corporate Development, Mr Augustus Tang, Director of Corporate Planning, and Mr Ian Shiu, General Manager of Revenue Management, Sales and Distribution. The fourth witness was Mr David Dodwell, a financial journalist, and currently head of the public affairs practice of communications group Golin/Harris Forrest in Hong Kong. Each of the Cathay officers gave evidence within his own

sphere of expertise, whilst Mr Dodwell spoke to the "urgent need" to continue the development of Hong Kong as a key international aviation hub in the face of rapidly emergent competition, and, against the background of the anticipated "steep growth" in tourist traffic between the mainland and Hong Kong in the coming decade, of the necessity to ensure that services to the mainland are "effectively interlinked" with Hong Kong's existing international network. We were favourably impressed with the range and quality of the evidence called by and on behalf of Cathay Pacific.

(b) Dragonair's case

22. In its Rebuttal Submission filed with ATLA, Dragonair strongly expressed its "fundamental disagreement" with Cathay Pacific's "assumptions, arguments and justifications" for its route licensing application. It submitted that the application to serve Shanghai, Beijing and Xiamen should be rejected on four specific grounds, stated to be as follows :

(a) the application is not consistent with the criteria prescribed by Regulation 11 of the Air Transport (Licensing of Air Services) Regulations, Cap.448A;

(b) it would upset a long-standing and well-working relationship between Cathay Pacific and Dragonair;

(c) it would have enormous negative financial implications for Dragonair and adverse economic implications for Hong Kong; and

(d) it could spill over into an increase in tension in the aviation relations between mainland China and the Hong Kong SAR.

23. At the time when the Rebuttal was submitted, the issue of the grant or otherwise of a licence for the three routes in question was essentially approached as a matter for the exercise of ATLA's discretion; as earlier noted, the direct challenge to ATLA's primary jurisdiction to entertain this dispute was a line of argument but subsequently developed, and thereafter notified to ATLA by letter.

24. We deal with the jurisdiction argument later in this decision. For immediate purposes, suffice to say that the suggestion canvassed at (d) above, namely as to an adverse effect upon inter-governmental aviation relations, was advanced also as an integral element within the submission as to the exercise of our discretion. As such, however, it finds no favour with this tribunal.

25. Not only does this suggestion import an unwarranted political 'gloss' into the specified statutory criteria within Regulation 11, but the idea of an "increase in tension" in inter-governmental aviation relations should ATLA be minded favourably to consider the present application strikes us as far-fetched, to say the least. The executive branches of the SAR Government and the Central People's Government are robust entities with their own policy agendas; they are highly unlikely, we respectfully suggest, to be discomfited or alarmed by the deliberations of an incidental statutory tribunal which is doing no more than to exercise its delegated authority to consider the merits of a particular licensing application in accordance with a statutory template. In so far as political considerations enter the arena, they do so at the next level, that is, at the table of inter-governmental discussion, and at that stage only. The idea that the task of ATLA, in vetting applications for licences, should in some way be

circumscribed by extrinsic 'political' considerations is both ambitious and misconceived. We reject this notion as firmly as we may.

26. As to the element of Dragonair's case particularized at (b) above, sounding to the Cathay Pacific/Dragonair relationship, we have earlier stated our view as to its relevance to this inquiry; we see no merit in further reflecting upon what seems to be put forward as a general preclusionary (and prejudicial) argument. The provenance and development of commercial relationships, and the implications arising therefrom, do *not* fall within the criteria against which the deliberations of ATLA are to be conducted. The only judgments that ATLA is prepared to make are those legitimately arising from an evaluation of the evidence in light of the provisions of Regulation 11; as such, therefore, only the propositions within (a) and (c) of the Dragonair summation fall within this purview.

27. In terms of the *viva voce* evidence led on behalf of Dragonair, four witnesses also were called. They were Mr Stanley Hui, Chief Executive Officer of Dragonair, Miss Olivia Lin, General Manager, Planning and International Affairs, and Mr Francis Wai, Chief Financial Officer. The fourth witness, albeit the first to go into bat for Dragonair, was Mr Mo Garfinkle, President and CEO of GCW Consulting, an outside airline consultant who, with his own team, was professionally retained by Dragonair to mastermind and co-ordinate its opposition to this application, and whom, as we understand the position, primarily was responsible for drafting the Dragonair Rebuttal Submission. We apprehend that Mr Garfinkle's vision and approach constituted a dominant and pervasive

influence over the manner in which Dragonair responded both to this dispute and to its hearing.

Current services on the three routes

28. Evaluation of the merits of the present application must take place against the background of the situation as it currently exists on the Shanghai, Beijing and Xiamen routes. Dragonair, of course, is not the only carrier on these routes, although it is the only Hong Kong carrier; in each instance a mainland counterpart (or counterparts in the case of Beijing) operates on these routes also.

(i) Hong Kong to Shanghai

29. Dragonair presently serves the Hong Kong/Shanghai route with flights eight times daily; 14 flights use A321 aircraft, and the remaining 42 use the larger A330, making a total of 56 flights per week.

30. Its mainland counterpart on this route is China Eastern Airlines. It runs 70 flights per week, that is, seven per day, with a mix of A340, A320 and A300 aircraft.

31. Hong Kong Civil Aviation Department (CAD) statistics for the year 2002 indicate that a total of 2,008,494 passengers were carried between Hong Kong and Shanghai, an increase of 16.3% over 2001.

(ii) Hong Kong to Beijing

32. On the Beijing route, Dragonair runs a total of 42 flights weekly, that is, 6 times daily, with an equal mix of A321 and A330 aircraft.

33. In this instance Dragonair has two mainland Chinese counterparts. The first is Air China, which runs a total of 35 flights per week, using B737 aircraft (14 per week), with the remaining flights shared equally between B747, B767 and B777 aircraft. The other mainland Chinese carrier is China Southern Airlines, which runs one B757 daily flight, that is, a total of seven per week.

34. Similar CAD statistics for 2002 show the total number of passengers carried between Hong Kong and Beijing to be 1,146,149, an increase of 8.3% over 2001.

(iii) Hong Kong to Xiamen

35. On the route to Xiamen, Dragonair runs 14 flights per week, that is, twice daily, using A320 aircraft.

36. China Southern Airlines also flies this route on a twice daily basis, its 14 weekly flights using B757 aircraft.

37. As to passenger numbers carried, CAD statistics reveal that a total of 278,648 passengers were carried by all carriers between Hong Kong and Xiamen, a decrease of 2.6% over 2001.

The core issue

38. As the tribunal observed on a number of occasions throughout the course of this hearing, the core issue in this case is that of the potential financial impact upon Dragonair consequent upon entry of Cathay Pacific

into the Shanghai, Beijing and Xiamen routes. This consideration formed the basis of the objection as originally filed, and it continued to inform the substance of Dragonair's opposition during the hearing.

39. The potential effect of Cathay Pacific flights being added — premised on a daily frequency of 4/3/1 — to the present route-mix has engendered graphic metaphors portending financial disaster for Dragonair should such a situation come to pass.

40. The Rebuttal Submission went so far as to suggest that to license Cathay to operate these routes would be to "cut the very heart out of Dragonair's corporate body"; elsewhere in the same document it is averred that the proposals to fly to Shanghai, Beijing and Dragonair "will add excessive and ruinous capacity to each of these markets relative to the demand and the current operators' continuous and continuing commitments to meet that demand, thus producing uneconomic overlapping". A like tone continued into the hearing, reference being made by Mr Hoo SC, leading counsel for Dragonair, to "the Hiroshima effect", this description later being discarded in favour of a "Pearl Harbour ambush", the latter in reference to the making of this application in the face of the existing management co-operation agreement between Cathay Pacific and Dragonair.

41. Clearly, therefore, the response thus evoked from Dragonair did not represent a shining example of moderation. Equally, however, the tribunal has been anxious to consider the justification for this unequivocal and uncompromising stance, and to examine the probabilities of such doom-laden prophecies coming to pass. It is one thing to evaluate

‘uneconomical overlapping’, to quote the language of Regulation 11; it is quite another should the grant of a licence to a competitor to fly certain routes prove responsible for the financial destruction of an existing operator upon such routes.

42. In considering the evidence thus put forward we remind ourselves in particular of two facets of this case which arise in connection with the burden of proof. First, we accept the submission that whilst the overall burden of proof remains upon the applicant to satisfy the tribunal that it should exercise its discretion to grant a licence, the evidential burden of proving specific allegations raised by one party, for example, as to specific detriment or financial loss, remains upon the party so alleging. It follows that in this case it is incumbent upon Dragonair to establish, on the probabilities, that it will suffer the loss it maintains will occur should Cathay Pacific be permitted to enter upon these three routes. Second, we further accept the proposition pressed on us by leading counsel for the applicant that, in principle, the higher the frequency enjoyed by an incumbent upon any particular route, the stronger must be the reasons in favour of the incumbent for the licensing authority *not* to grant capacity to the new entrant. This principle — which we note is applied with approval in decisions of the licensing panel of the English Civil Aviation Authority — in our view achieves yet greater resonance when placed against the background of an incumbent which now has enjoyed an effective monopoly over the routes in question for the past twelve years.

43. As objector to this application, Dragonair prays in aid specific matters in support of its position. It says that there will be a catastrophic drop in passenger numbers should Cathay Pacific be allowed onto the

scene, and that as a consequence the airline will suffer extreme financial loss, co-terminus with the virtual destruction of its China-wide network. We examine these elements individually.

(a) Loss of passenger numbers

44. The issue of how many passengers will be lost to Dragonair should Cathay Pacific gain entry to the Shanghai, Beijing and Xiamen routes is an aspect which has hung heavy over this inquiry, not least because, at best, this can only be a matter for educated speculation. That the question is speculative is agreed; where the parties strongly differ is in the choice of model appropriate to provide the answer.

45. The Dragonair position is that it will lose a total of 558,909 passengers if Cathay is allowed onto these routes. This cumulative figure is broken down, from 2002 levels, into 313,674 on the Shanghai route, 221,327 on the Beijing route, and 23,908 passengers on the Xiamen route; in turn it is said that Dragonair's load factors on these routes will be reduced to 41.4%, 29.1%, and 39.3% respectively — as compared, for example, with January-June 2002 route load factors cited in the Rebuttal Submission of 74%, 62% and 57%.

46. Cathay Pacific's stance, on the other hand, is that their best estimation, on the basis of the frequencies applied for, is that entry onto these three routes will produce a reduction in Dragonair's total passenger numbers by 228,384, that is, but 40.8% of the Dragonair projection.

47. The projected Dragonair passenger loss is derived from a model utilized by their professional consultant, Mr Garfinkle, which is termed the 'QSI Model', a complex theoretical structure which is developed by looking at the share of each carrier in a given market and the varying types of traffic flow within that market; in his evidence Mr Garfinkle spent a considerable amount of time outlining the constituent elements of this model, including the variety of, and justification for, the assumptions therein employed.

48. For its passenger projections Cathay Pacific used its own model, sometime termed a "stimulated growth model" which it is said to have taken several years properly to calibrate. The broad picture painted by Cathay Pacific in terms of 'target traffic' for the year 2003 after assumed CX entry onto the three routes is that a total of 1,106,395 passengers would be carried on these routes; the components of this figure being 616,010 passengers on the Shanghai route, 380,814 for the Beijing sector, and 109,571 for the Xiamen sector.

49. Of this total figure of some 1.1 million passengers anticipated to be carried, in addition to the 228,384 which would be taken from Dragonair, it is also estimated that a further 286,008 passengers would be derived from the counterpart mainland carriers operating on these routes, some 161,165 arising from the natural growth of the existing origin and destination ('O&D') market on the three routes, and a further 430,838 taken from that which throughout the course of this hearing was referred to as 'the beige area' or, simply, 'the beige'.

50. This latter description had as its origin a bar chart introduced into evidence fairly early in the hearing by Mr Augustus Tang. This chart, entitled 'Estimated Traffic To/From Mainland Points', purported to show the alteration in market share on the three routes between 2002 and 2003 arising from Cathay Pacific's entry, the area coloured 'beige' on each bar of this chart signifying the very significant proportion of traffic flying into each of these three mainland destinations which presently did *not* go via Hong Kong; it was from this latter passenger traffic that Cathay Pacific anticipated that it would be able to cull in excess of 400,000 passengers if it should now to be permitted to extend its own route network into China, and thus significantly develop Hong Kong's status as an international aviation hub.

51. The introduction of this bar chart, together with Mr Tang's evidence in relation thereto, provoked an extensive request for particulars, and the response to such particulars, as thereafter put into evidence, revealed in outline the elements and methodology of the model used to produce Cathay's passenger forecasts.

52. We decline to embark upon a detailed critique of the respective approaches to forecasting passenger loss and reduced load factors. The adversarial process (which we are far from satisfied is best suited to an inquiry of this nature) will, even with the best intentions, tend inevitably to produce data skewed to the advantage of the particular proponent, and the huge variation in the figures in terms of estimated passenger loss tends to underscore the point.

53. Having said that, we have reflected at length upon this strikingly disparate evidence, and we have little doubt that the position put forward by Dragonair is very significantly inflated. The 'QSI model', and the results issuing therefrom, in our view does *not* constitute a reliable indicator of that which is likely to occur should Cathay be permitted to enter the market on the routes in question, particularly since the theoretical assumptions employed therein do not appear to us realistic and fairly weighted — for example its input data comprising CAD statistics made no distinction between O&D and connecting passengers and different destinations for circuity, nor did it take account of the latest actual CAD figures in terms of growth rates on these routes and nor, for that matter, was any account taken of the huge untapped potential within the 'beige' market. We further accept the submission that the secondary Dragonair 'calibration model', which was put forward as corroborating the QSI results, is itself affected by input from the main model, and is thus rendered equally problematic.

54. Our rejection of the Dragonair projections, however, does not necessarily imply total acceptance of the Cathay Pacific data, nor do we accept the submission that the omission to put to the Cathay witnesses in cross-examination the Dragonair criticisms of the Cathay model/figures — an omission which led to a procedural ruling which regrettably coloured the course of this inquiry — necessarily resulted in the Cathay figures being regarded as conclusive. Procedural difficulties aside, it is fair also to say that we had some reservations about the Cathay model, particularly in light of the increasing incidence of direct flights into Shanghai and Beijing from other major world cities, although in our view the figures thus

produced are likely to prove very much closer to the mark than those currently projected by Dragonair.

55. Whilst we accept that the approach canvassed by Cathay Pacific is based upon actual data and extensive practical marketing and planning expertise and experience, we were not assisted by the idiosyncratic manner in which these figures actually emerged — absent the seeking of particulars consequent upon Mr Tang's production of the bar chart and his evidence with regard thereto, no element of the Cathay Pacific methodology, as elucidated in the response to this request for particulars, would have been explained. Nor are we fully convinced that 'the beige', as it was universally characterized, necessarily will yield the volume of passengers anticipated by Cathay Pacific, although we accept the validity of the underlying concept, which embraces the obvious possibility of attracting new passenger traffic to the Hong Kong hub, as we further accept Mr Tang's evidence that securing only a very small percentage of this presently untapped market would suffice in order to justify the figures as now advanced. In any event, and perhaps more important, we do not consider that it follows, as Dragonair now strongly asserts, that the passenger numbers presently anticipated by Cathay Pacific to be garnered from this new and as yet untapped source will in practice inevitably be 'stolen' from Dragonair. In this connection we think that Mr Tang was correct when he suggested that the Dragonair approach towards passenger numbers amounted, in effect, to a "zero sum game", and that it was in error in overlooking the possibilities to 'grow the market' via cultivation of the vast number of passengers presently flying into China *otherwise* than through Hong Kong. In fact, it seems not unlikely that any

such market growth ultimately may enure to the benefit of Dragonair, given an inevitable passenger 'spillage' factor.

56. Our conclusion on the models, therefore, is not to be represented as entirely clear-cut. Although we reject the figures for total passenger loss as now propounded by Dragonair, and incline firmly to the broad dimensions advanced by Cathay Pacific as to the likely impact of entry, nevertheless we remain unwilling to hang our hats upon any particular figure, as ultimately we were invited to do. Although to do so would be comforting, we remind ourselves that in this area the tribunal is dealing solely with extrapolations and projections as opposed to hard data, and that in any event it is clear that such projections as have been variously put forward would be correspondingly affected if the frequencies as presently sought under this application in fact were not to be granted.

(b) Financial impact

57. We consider that there is justification for the criticism leveled at Dragonair by Mr Haddon-Cave QC that its case on the financial effect of Cathay Pacific's entry lacked inherent consistency; his metaphor of "constantly shifting sands" struck us as reasonably apt.

58. The high watermark of Dragonair's case in this regard occurred at the outset, the Rebuttal Submission pitching the anticipated Dragonair loss of revenue consequent upon such entry at approximately HK$1 billion (that is, $1,000 million). This figure is broken down into "a more than HK$500 million" revenue loss on the Shanghai route, a "more than HK$400 million" revenue loss on the Beijing service, and a revenue loss of "around HK$35 million" on the Xiamen route. These figures are

extrapolated from the passenger number loss derived from the QSI model, and we are unable to accept them. In our view the figure of HK$1 billion represents that which we are forced to conclude is a very considerable exaggeration of the probable position.

59. Other figures variously put forward by Dragonair at different times during the hearing ranged from a total revenue loss of HK$994.5 million to HK$780 million to $606.8 million to HK$551.5 million. It is fair to point out that the revenue loss figures at the lower end of this scale arose from schedules produced in the course of Mr Francis Wai's examination when attempts were made to model the projected revenue loss upon differing bases, including in particular modelling the financial impact on Dragonair utilising Cathay Pacific's own passenger reduction figure of 228,384. This latter exercise, however, in our view was less than satisfactory given that it appeared to fall prey to the twin perils of understatement of revenue together with overstatement of costs, with correlative unreliability of result; other exercises adopted the highly questionable figures from the QSI model, and yet further ignored the passenger numbers anticipated to be yielded from 'the beige'.

60. A particular instance of the volatility of the passenger projection figures which struck us as telling occurred when Mr Wai, the final witness to give evidence in this hearing, was placed in the position of having to explain how the figure cited in the Rebuttal Submission for an annual projected loss on the Shanghai route of "over $100 million" became transmuted during the hearing to a loss of some HK$258.2 million, notwithstanding that the only unavailable data at the time the Rebuttal Submission was drafted were the figures for December 2002. In an attempt

to justify such a sudden deterioration in the projected financial position, and this apparently as the result of further inputting data for but one month only, Mr Wai was unable to do more than to seek refuge in the lack of precision implicit in the use of the word "over" within the original Rebuttal estimate, an explanation which did little to mollify the tribunal. In this connection we wish to stress that we have no wish to appear overly critical nor to imply that we consider Mr Wai to be other than a reputable accountant and, no doubt, a good CFO; as with each of the Dragonair officials who gave evidence — and whom as individuals created an impression of loyal, capable and wholly-committed officers of this airline — we formed the view that the content and complexion of the case they were required in this hearing so vigorously to defend may not always have constituted the battleground of their choosing.

61. Cathay Pacific's approach to the issue of Dragonair's projected financial loss, in contrast, was more straightforward. We have earlier observed that it was not until towards the end of this hearing that hard contemporary financial data was forthcoming from Dragonair. Accordingly, having received on Day 8 of the hearing information as to passenger yield for the three routes in issue, Cathay proceeded to compute that a reduction of 228,384 passengers (to take their figure) would cause Dragonair a loss in revenue of HK$328,223,866, a sum which, as Mr Haddon-Cave pointed out, amounted to a reduction in revenue of approximately 30% of that put forward by Dragonair, and still leave a healthy overall profit.

62. This latter submission as to an healthy profit post-dating Cathay's entry onto these routes was able to be made by reason of the

disclosure by Dragonair, again on Day 8 of the hearing during the evidence of Mr Wai, of a summary of the Dragonair Management Accounts for the year ending 31 December 2002. The evidence in this regard was that although the audited accounts had yet to be formally signed off by the auditors, the accounts to be so verified reflected the information contained in the Management Accounts summary, and as such was to receive audit approval without qualification.

63. The information as summarized in these Accounts portrays an airline in rude financial health. For present purposes, the broad picture will suffice. The 2002 Dragonair results reflect total net revenue of some HK$5,885 million, representing growth of 21.8% over 2001, of which some $4,196 million is attributed to passenger revenue, an increase of 11.3% over the preceding year, an operating profit before interest of HK$544.5 million, an increase of 67.5% over the preceding year, and a consolidated net profit of HK$540.8 million, representing a growth of 59.6% year on year.

64. If we may say so, these are not insignificant figures. And, it seems to us, the picture thus revealed does not immediately serve to reinforce the Dragonair case that financial disaster inevitably will strike if Cathay Pacific now be allowed, upon a restricted basis, to operate on the Shanghai, Beijing and Xiamen routes.

65. We recognize, of course, that two of these routes, namely those to Shanghai and Beijing, represent the “golden routes” of the Dragonair route network within China. In this connection we have had sight of a ‘Route Profitability Schedule’, which again was adduced during

the evidence of Mr Wai and which similarly is based upon the 2002 audited accounts. This schedule is compiled with reference to the type of aircraft variously operated on each route — there are separate entries for the operations of the A320/321/330 respectively — but the broad picture emerging is that on the Shanghai route the actual net profit, after overheads, was HK$523.7 million, whilst on the Beijing route the equivalent figure stood at HK$104.3 million. In terms of these two routes, also, the average revenue load factor is recorded as at 74.8% for Shanghai and at 64.5% for Beijing; for Xiamen the figure for average revenue load factor is stated at 59.9%, with an actual net profit recorded of HK$0.28 million.

66. Looked at in the round, therefore, we do *not* consider that the 'financial devastation' scenario has been made out by Dragonair. In our view such a conclusion is unsupported by the evidence, and we firmly reject it. As Cathay Pacific accept, undoubtedly there *will* be a financial impact if it were to succeed in this application, but upon the evidence before this tribunal we have concluded that such impact manifestly will be of a different order and be very considerably less than the impact which Dragonair has endeavoured to establish.

(c) Loss of Dragonair's China network

67. We deal with this as a necessary adjunct to the previous heads because the issue of the loss of Dragonair's route network in China is interlinked with that of the projected passenger loss on the Shanghai, Beijing and Xiamen routes and the financial consequences thereof.

68. Much play has been made of the deleterious effect Cathay's entry onto the Shanghai, Beijing and Xiamen routes is likely to have in terms of the continuation of Dragonair's wider route network as presently existing in mainland China. The Rebuttal Submission puts the case high, maintaining that the impact of such entry "would do more than simply cause Dragonair to review its cross-subsidisation of loss-making routes to secondary mainland China points. It would force a collapse in Dragonair's network, with major reductions in service and wholesale cuts in routes …" In this context a weakening of the links between Hong Kong's economy and that of the mainland is also prayed in aid, it being asserted that "Dragonair's role as an economic conduit reaching out from Hong Kong into Mainland China would end and not be replaced from within Hong Kong."

69. This theme was continued into the hearing, with wall-charts exhibiting the situation 'before' and the 'after' Cathay Pacific entry, the 'after' exhibit illustrating a dramatically denuded effect within the existing Dragonair network with the excision of all but five of the 19 routes on which Dragonair currently operates, the other 'surviving' routes, in addition to Shanghai, Beijing and Xiamen, being Chengdu and Hangzhou. In forensic terms this exercise no doubt provided passing interest; we remain unconvinced, however, that any real weight should be attached to this argument.

70. If and in so far as Dragonair is content to operate at a loss on 15 of its current 19 mainland routes, as it maintains now is the case — we note, however, that operation on 13 out of these 'loss-making routes' nevertheless still yields a positive cash margin — so be it; this situation

seems to us to be entirely a matter for the commercial judgment of Dragonair's management. We fail to see, however, why cross-subsidization of these secondary routes from the profits of the principal 'thick' routes to Shanghai and Beijing should in itself be a factor instrumental in precluding entry of a competitor onto such highly profitable routes if the benchmark tests for entry are otherwise satisfied. Nor, if we may say so, are we convinced, in terms of these secondary 'unprofitable' routes, that Dragonair is making optimum use of its available capacity on these other mainland routes.

71. We would observe, further, that issue of cross-subsidisation of Dragonair's secondary mainland routes is not to be imported into the concept of "uneconomical overlapping" (to which we turn in more detail below). We accept and adopt the proposition, which we had not thought controversial, that "uneconomical overlapping" is 'route-specific' and not 'system-wide', and thus does not sanction an argument that the incumbent should be allowed to remain unaffected on highly profitable routes in order to cross-subsidise other routes, and thereby ensure a system-wide return.

72. Finally, and in any event, it does not seem to us that the Hong Kong public interest necessarily is best served by continued maintenance of an unprofitable secondary route network — on routes which continue to be served by other carriers — if such comes at the stipulated price of preventing otherwise justifiable competition upon major, and hitherto rapidly expanding, routes into China. In this instance, unprofitable secondary routing does not fit happily into the mould of public service virtue.

'Uneconomical overlapping'

73. Given that a key element within the objection before us is that Cathay Pacific's entry onto each of these three routes will cause "uneconomical overlapping", we take the opportunity to deal separately with this aspect, although undoubtedly elements relevant to this issue have arisen peripherally during consideration of that which we have characterised as 'the core issue'.

74. There is no dispute as to the meaning to be attributed to "uneconomical overlapping". Both parties agree that this term is to be understood in the manner in which it was explained in an ATLA decision of 31 August 1987, a decision which, ironically in the current circumstances, involved an application by Dragonair, as then opposed by Cathay Pacific, for a licence to operate the Hong Kong/Beijing and Hong Kong/Shanghai routes and *vice versa*. In its Decision rendered upon that application the ATLA tribunal, of which the late Mr Justice Ross Penlington then was its eminent Chairman, stated as follows :

> "Would licensing Dragonair for Shanghai create 'uneconomic overlapping'? Mr Foster considered that phrase meant that capacity on the route was such that at least one carrier would lose money. **We would prefer the phrase used in the United Kingdom that there should not be such excessive capacity as prevented a reasonable return to an efficient operator …**" (emphasis added)

75. The constituent elements within this definition are capacity, reasonable return, and efficient operation.

76. In terms of capacity, it is difficult immediately to appreciate how excessive capacity can be prayed in aid in the context of the present

objection when the objector itself is intending to *increase* frequencies on these routes.

77. The undisputed evidence is that, from summer 2003 onwards, Dragonair plans to increase the frequencies to Shanghai from eight to ten per day, that is, 70 per week, to increase the flights to Beijing from six to eight per day, namely 56 per week, and, from winter 2002, there already has occurred an increase in its weekly service to Xiamen from 11 to 14, that is, two flights per day.

78. This information, which was confirmed in the Dragonair evidence, was brought into sharp focus on the fourth day of the hearing with the production, it must be said by objector and not by applicant, of a Dragonair internal memorandum dated 9 August 2002 from the Planning & International Affairs Department to the CEO. This internal memorandum — Mr Haddon-Cave's so-called 'smoking gun' — contained revealing management insights, and we understand that it did not find its way to Mr Garfinkle at the time when he and his team were compiling the draft of Dragonair's Rebuttal Submission.

79. In this memorandum the proposed increase in frequencies to Shanghai is stated to represent an increase in weekly capacity from 14,588 seats to 18,648 seats, or 28%, such increase being "in line with the growth of KA's traffic on this route, which was 28% in the first half of 2002, 30% in 2001 and 36% in 2000"; the author further notes that the total Hong Kong/Shanghai market is said to have seen a growth of 20% in 2001 and 18% in 2000, and in terms of passenger load "we averaged 74%

during Summer 02 season so far, a clear sign that more capacity is required."

80. So far as the increase in frequency to Beijing is concerned (already increased from five to six flights per day since the beginning of the Summer'02 season), the memorandum observed that the load factors had been "very good, averaging 70% in Summer '02 so far", and that it was proposed to add two more A321 flights daily to bring the frequency up to eight flights per day.

81. The anticipated increase in the Dragonair fleet, in terms of one A330 delivery (in December 2002) and two A321 deliveries (in June and August 2003) is also noted within the memorandum, as is the continuing growth in the China market. In this connection, a growth rate of 18% is anticipated for the Hong Kong/Mainland passenger market in 2003, together with a budgeted ASK (Available Seat Kilometres) growth of 18% on the mainland routes, a statistic which does not happily sit with the figure of an anticipated 9% China market growth cited within the Rebuttal Submission filed with ATLA by Dragonair. It is also fair to note that the element of market growth referred to in this August 2002 memorandum in itself is consistent with projections in a Dragonair 'frequency plan for 2001 to 2003', as referred to in the Dragonair Executive Committee Minutes dated 25 April 2003 which were placed before us by the objector, which noted the updating of that frequency plan assuming "a growth rate for passenger market of 15% p.a. for China routes and [is] targeted to achieve 50% market share on most China routes with a load factor of 70%".

82. Dragonair's obvious confidence as to growth of the China market is exemplified by the published passenger growth rates in the available CAD statistics, to which we earlier have referred. In addition, Dragonair's clear success within the prime Shanghai, Beijing and Xiamen routes is evidenced by its own demonstrable increase in market share specific to those routes; figures extracted from the relevant CAD statistics indicate that the Dragonair market share increased in 2002 over 2001 by 22.4% on the Shanghai route, by 16.1% on the Beijing route, and on the Xiamen route by 29%. Load factor statistics tell a similar story. CAD statistics indicate that in 2002 Dragonair obtained a load factor of 75.5% on the Shanghai route as a whole (as against a total market load factor of 69.2%), of 63.9% on the Beijing route (against a total market 58.6%), and of 61% on the Xiamen route (against a total market 55.7%). In our view these figures are not unimpressive, and do not serve to make the case that the grant of a licence to another Hong Kong carrier to operate on these routes would result in "uneconomical overlapping".

83. Viewed overall, therefore, the man on the Shaukiwan tram, that quintessentially reasonable observer of Hong Kong affairs, might be tempted to conclude that Dragonair clearly is prospering on these routes, and that its objection to the present licence application is founded as much upon preservation of a favourable bottom-line as upon broader considerations of public interest. In this context, also, we bear in mind the fact, as Mr Hui acknowledged in his evidence, that some 80% of Dragonair's revenue on its mainland routes is dependent upon three out of the 19 routes currently in operation.

84. In terms of frequency increase, we further note that it has been said on several occasions during this hearing — notably by Mr Garfinkle and by Mr Hui — that frequency is perceived by airlines as co-terminus with market share. Mr Hui stated as much in the context of his evidence regarding Dragonair's aspirations as to market share on the Taiwan route, whilst Mr Garfinkle appeared to consider this an inalienable general proposition. His position was that frequency should be piled upon frequency in order best to 'fight' the competition, whilst in final submission Mr Hoo stated the position to be that Dragonair "is adding frequencies to keep its load factors from reaching the critical level where passengers are being turned away". On this thesis, therefore, and given that Dragonair's frequency increases are anticipated to be matched by the counterpart mainland carriers on these routes, the contention arises that there simply is no room for any new entrant upon these routes.

85. This is an obvious 'bootstraps' argument, and if it had any validity — which in our view patently it does not — the result would be that existing carriers on any given route could preclude the entry of a competitor simply by continuing to raise frequencies whilst invoking the statutory rubric of 'uneconomical overlapping'. We unequivocally reject any such argument upon these lines, and in any event we accept the proposition that use of the phrase "an efficient operator", as included within the accepted definition of 'uneconomical overlapping', effectively precludes such approach; 'efficient operators' do not raise frequencies and diminish load factors beyond what are regarded as acceptable commercial levels, the operation of market forces inevitably constituting an appropriate arbiter of such levels.

86. To an extent, of course, the concept of “a reasonable return” is a movable feast, and depends as much on the eye of the beholder as upon any absolute level. In his evidence Mr Tang noted, on the basis of IATA data, that the aggregate “industrial norm” is represented by a route profit margin of 3%, although in answer to a question from the tribunal he indicated that his view of a ‘reasonable return’ on the routes on which it was desired now to enter would be “around 8 to 10%”, whether for Dragonair and Cathay Pacific : “if they are sensible, if we are sensible”.

87. Mr Tang also made the fair (and indisputable) point that different routes have different profit margins, an observation which prompted the tribunal, late in the second tranche of this hearing, to request evidence from Dragonair as to its profit margins on the routes presently at issue. In turn this led to the production by Dragonair, during the evidence of Mr Wai, of a most useful document entitled ‘Profit Margin Summary from 1993 to 2002’ which helpfully set out the Operating Cash Margin, the Gross Profit and the Net Profit margins for all the Dragonair scheduled services to China during this decade. The information therein was of considerable assistance.

88. So far as Shanghai was concerned, the Gross Profit margin for 2002 was 41.5% and the Net Profit margin 28.8%, for Beijing 21% and 9.5%, and for Xiamen 20.9% and 0.2% respectively. In our view these gross profit margins of 41.5%, 21% and 20.9% are particularly revealing, given that these figures remain unaffected by the attribution of costs, the varying premises for costs attribution being something we have found problematic in this inquiry. In fact, on the basis of these figures in this ‘Profit Margin Summary’ over the 10 years in question the average GPM

for Shanghai has been 44.64%, for Beijing 38.3%, and for Xiamen 34.82%, by any yardstick outstanding figures we should have thought.

89. These figures are perhaps hardly surprising given the similarly outstanding frequency growth over the past five years on the two main trunk routes, the 18 weekly frequencies in 1997 on the Shanghai route increasing to 56 by 2002, and the 16 weekly frequencies in 1997 on the Beijing route increasing to 42 by 2002, with an additional 14 weekly frequencies planned for each route for 2003. Frequency on the Xiamen route, by contrast, has merely doubled since 1997, from seven weekly at that time to the 2002 figure of 14 per week.

90. A further exercise carried out in the course of this hearing, once again on the accepted basis that market share is a function of frequencies, and on the further assumption that Cathay Pacific had entered these three routes in 2002 in terms of the 4/3/1 daily flights as now sought, reveals that on the Hong Kong/Shanghai route the Dragonair market share would have been reduced from 55.3% to 36.3%, on the Beijing route from 53.7% to 40%, and on the Xiamen route from 46.8% to 40%, the figure for the existing Dragonair market share prior to such assumed Cathay Pacific entry being extracted from the relevant Hong Kong Civil Aviation Department statistics for 2002. Once again these figures do not support the case that entry on the restricted basis mooted will be causative of a Dragonair financial meltdown.

91. This latter exercise, also, tends to support that which Mr Tang at the outset of his evidence had described as a "crude sanity check", a simple back-of-envelope calculation based on the wish of Cathay Pacific

to operate four daily flights to Shanghai in comparison with the daily frequencies of Dragonair and the counterpart mainland carriers; this calculation produced a figure of 16.7% of the total number of daily flights for Cathay Pacific as against a figure of 32% market share attributed to Cathay Pacific within Dragonair's model, and for Beijing a figure of 18% as against the Dragonair-modelled figure of 36.5%.

92. The point obviously must be borne in mind that exercises such as this are not in themselves definitive, but undoubtedly they provide some much-needed perspective, and certainly do not support the image sought to be conveyed throughout this inquiry of Cathay Pacific as corporate predator intent upon hijacking the rich China routes and in the process seeking to cut its former progeny's financial throat.

93. In our view the data that we have examined fails to establish the 'uneconomical overlapping' for which Dragonair contends, and we reject this case as mounted. To the contrary, the assembled figures relating to these routes in terms of revenue, load factors, gross profit margins and passenger growth point to the conclusion that indeed there is room for the entry of Cathay Pacific onto these routes on a restricted basis. Profit levels undoubtedly *will* be affected by such entry of another carrier, but in no sense do we believe that the reduction in such levels will result in prevention of a 'reasonable return', as Dragonair consistently have claimed.

Public interest considerations

94. We recognize, of course, that at bottom the driving force for this application by Cathay Pacific, or indeed of any application of this

nature, remains one of economic self-interest. Publicly-listed companies are not charitable organizations; properly-run, their prime interest is in making profit, and equally they must account for their results to their shareholders. We do not regard this applicant as being an exception to this immutable commercial doctrine. In this instance Cathay Pacific makes no secret of the fact that access to these mainland Chinese routes constitutes the final piece of the jigsaw in terms of its world-wide route network, and it further makes the fair point, it seems to us, that it cannot be regarded as a truly global airline if it is unable to serve the major cities in the very country wherein it is based. That said, however, we have not overlooked the general considerations of public interest that have been put forward by Cathay Pacific as also justifying its wish to enter upon these routes. As Regulation 11 makes clear, public interest considerations provide the broader canvas against which the specific aspects of the particular licence application are to be evaluated.

95. We consider that within the wider 'public interest' context there is little room for cogent opposition. We do not accept the bald proposition, for example, that Hong Kong no longer functions as a gateway into China. The advent of direct international flights into Shanghai and Beijing indeed may have removed the historical necessity of gaining access to China through Hong Kong, but we reject the idea that it follows that Hong Kong has ceased to have utility in this regard such that this element of the equation can or should be dismissed or accorded little, if any weight.

96. We maintain the view that Hong Kong — which has the good fortune now to possess one of the world's great airports — remains an

important factor within the immensely fast-developing world of Chinese aviation, and should continue to be regarded as such. It follows that the arguments put forward on behalf of Cathay Pacific regarding the further and better development of Hong Kong as an international 'hub' are arguments which, in our judgment, cannot respectably be gainsaid, and we remain wholly unsympathetic to the noticeable efforts made by those charged with framing Dragonair's opposition to minimize this aspect of the case on the basis that Hong Kong is no longer to be considered a 'gateway' to the mainland.

97. In particular, whilst we do not wish to pitch this too high, we further accept that the desire of Cathay Pacific to promote Hong Kong's status and development as an international 'hub' — in terms specifically of enhancing same-airline connectivity between the applicant's China flights and the rest of the world, thus facilitating international passenger flows and cargo *via* Hong Kong — represents an wholly worthwhile aim, and one that should not be diminished or overlooked in favour of rapidly-growing foreign 'hub' airports, such as Singapore, Bangkok, Seoul, Tokyo, all of which are in the process of becoming major hubs for China as their 'home' airlines channel traffic between their China services and other connecting flights. We accept, also, as Mr Dodwell suggested, that Hong Kong's 'home' carriers build their route network out from the 'home hub', and that their own commercial interests are indelibly linked with the dynamism and success of that hub.

98. Accordingly, it may be that in this element of the case there is a welcome coincidence between motives of corporate self-interest and those of the wider public interest. The fact that Hong Kong ought to

dominate as an international hub serving China is not an idea peculiar to the applicant, Article 128 of the Basic Law purporting to enshrine a not dissimilar proposition :

> "The Government of the Hong Kong Special Administrative Region shall provide conditions and take measures for the maintenance of the status of Hong Kong as a centre of international and regional aviation."

99. In an immediately practical sense, also, there can be no doubt that entry of another reputable carrier onto the major air routes into China is likely to enure to the benefit of the Hong Kong consumer, providing competitive fares and a greater element of choice for travellers between Hong Kong and the three mainland destinations in question. In this regard we steer clear of immediately embracing the suggestion that the applicant's participation upon these routes will ensure lower fares necessarily or at once — we remain conscious of Mr Ian Shiu's cautious assertion in evidence that if granted a licence Cathay Pacific initially would attempt to "match" Dragonair's existing fare structure — but at bottom we repose confidence in the immutable law of supply and demand. In the absence of the grant to Cathay Pacific of a licence to fly on these routes, and thus of the introduction of an element of competition, we venture to suggest that the objective Hong Kong bystander would be disinclined to wager any money on the chance of any voluntary reduction in the fares presently charged by Dragonair, or indeed by the counterpart carriers on the Shanghai, Beijing and Xiamen routes. The fare levels currently in place were characterized in Mr Dodwell's evidence as "artificially high" and to the detriment of Hong Kong's status as a business and tourism centre for China, one effect of such fares being to drive travellers cross-boundary,

chiefly to Shenzhen, in order to fly to mainland cities, whilst at the same time constituting an economic incentive for travellers to and from overseas destinations to bypass Hong Kong and to use alternative gateways into China. We agree with and accept these views.

100. It follows from the foregoing, therefore, that in so far as the mandate as to general licensing policy within Regulation 11 necessitates regard to "the co-ordination and development of air services generally with the object of ensuring the most effective service to the public while avoiding uneconomical overlapping and generally to the interests of the public", we consider that, from the economic viewpoint at least, the case has been established in principle. Consideration of the specific matters delimited in (a)-(d) of Regulation 11, namely the existence of other air services and the demand for air transport in the area, the degree of efficiency and regularity of the air services already provided, and the period for which such other air services have been provided, serve to reinforce this conclusion.

'One route, one airline'

101. The point, however, does not begin and end with economic considerations. In the context of his argument that, as a matter of the exercise of its discretion, this tribunal should reject the present application, Mr Hoo strongly submitted that the requirement within Regulation 11 to "have regard to the co-ordination and development of air services generally" connoted that there could be no such co-ordination and development *absent* regard to Government policy in this area.

102. Historically, the policy of 'one route, one airline' was introduced by the Government of Hong Kong in 1985. Hong Kong Hansard for 20 November 1985 contains a statement by the late Sir John Bremridge, then Financial Secretary, on Air Transport Policy; the extract reproduced below is pertinent, and therein is highlighted the passage upon which particular reliance in placed by Dragonair :

> "… international air transport is highly regulated. Air traffic rights are not available to all and sundry. Such valuable rights are jealously guarded and governments seek to retain the maximum share for their own airlines. Often there is only one international carrier, which may well be wholly or partly state-owned. Consequently, many, if not most, bilateral air services arrangements provide for only one airline to be designated by each party to operate all its routes; others permit no more than one airline per route for each side.
>
> In these circumstances designation of more than one Hong Kong airline on any route would be considered only in circumstances where it was judged that more competition was needed in the public interest and the traffic was sufficient to sustain a substantial operation by more than one Hong Kong airline. At the present time however the most heavily travelled routes to and from Hong Kong are already well served by several established operators. **The Government has therefore decided that as a general rule, and subject to the existing arrangements in any given case, designation in respect of routes available to Hong Kong will be limited to one airline per route**. The airline first licensed by ATLA for a route will normally be the one to be designated for that route …"

103. It was further noted that in 1996 the Hong Kong Government had affirmed its position of a decade earlier. In oral answer to a question — asked against the background of the then recent agreement between Swire, Citic Pacific and CNAC as to ownership of Dragonair — as to whether there had been any change to the 'one airline one route' policy, the then Secretary for Economic Services repeated the content of the earlier statement, stressing that designation of more than one

Hong Kong airline on any route would be considered only where it was judged that more competition was needed in the public interest and that the traffic was sufficient to sustain a substantial operation by more than one Hong Kong airline; at the same time he added the caveat (upon which Mr Hoo also now strongly relies) to the effect that :

> "It would not be in Hong Kong's trade and other economic interests to see internecine competition by Hong Kong airlines weakening their overall ability to compete against foreign airlines …"

before concluding thus :

> "… the general rule of 'one airline one route' has served Hong Kong well up to the present and the Government sees no reason for change."

104. Viewed in the round Mr Hoo's argument, as we perceive it, amounts to the following : the express Government preference for 'one route one airline' is a policy which itself should inform this tribunal's decision, and on this basis alone the application should be rejected; but that if, as he put it, the existing policy "is to be completely abrogated" and "the past 13 years of co-ordinated growth and beneficial co-operation between the two airlines" is to end, then the policy should be "dismantled in an equitable and fair way to preserve a level playing field for all parties". He went on to suggest that it was presently impossible for there to be a level playing field given the manner in which Cathay Pacific had dictated Dragonair's development as a short-haul airline within China, and that it simply was not possible for Dragonair to change its aviation profile overnight, and, for example, to make the transition to long-haul carrier in order more generally to compete with Cathay Pacific. In essence, therefore, Mr Hoo argued that to permit Cathay now to infringe upon these

routes would constitute both a conflict of interest and amount to unfair competition, a situation that could not fairly be considered in light of the dictates within Regulation 11 as to "the co-ordination and development of air services generally".

105. We hope that this represents a fair summation of an argument that took in a variety of concepts during its eloquent exposition. It seems to us, with respect, that it is wrong. Perhaps it would assist if we shortly comment upon what appear to us to be the competing propositions within Mr Hoo's analysis.

106. First, at the outset of this decision we emphasised that in discharging our function *qua* ATLA tribunal seized with a disputed licence application we are disinclined to arrogate any particular significance to the commercial history and relationship as it existed (and continues to exist) between these two airlines. Whether, as Mr Hoo submitted, Cathay Pacific now desires "a divorce of the most strident kind", or indeed whether it has a "hidden agenda" to undermine Dragonair's ability eventually to put up proper and healthy competition to Cathay Pacific over both short and long-hauls is in our judgment not a matter with which we should be concerned, given the confines of our statutory mandate, although we would observe that in purely commercial terms we consider this to be a curious proposition given the fact that Cathay Pacific remains a major shareholder in Dragonair. In the event, of course, we have concluded that Dragonair's financial existence is *not* so threatened.

107. Second, and with particular reference to that part of the submission as relates to the concept of 'unfair competition', we note here

the reliance upon Professor Dempsey's views, which are encompassed within the following statement, as contained within the Rebuttal Submission, that :

> "Dragonair must be given both the tools and the time to develop those tools before Cathay Pacific can be allowed to 'overlap' with Dragonair, especially on, as Cathay Pacific well knows, Dragonair's two most profitable routes. Without that time and those tools, the 'overlap' will become an easy 'overwhelm' for Cathay Pacific …"

108. Professor Dempsey was not called to give evidence, the position being that Cathay Pacific did not require his presence for cross-examination, although there was attribution to him in this part of the Rebuttal Submission. This is not entirely satisfactory from an evidential standpoint, but at the end of the day perhaps it does not greatly matter. Hong Kong has no 'unfair competition' legislation such as exists in other jurisdictions, and absent specific legislative restraint, we do not consider that this concept as understood under statutory regimes elsewhere should, in effect, be imported into the statutory rubric of Regulation 11 by the back door.

109. Third, and by far most important, in our view this entire argument, cultivated from the fertile ground of government policy and deftly fertilized with the waters of 'unfair competition', strikes us as standing upon a fundamentally incorrect premise. There is, and can be, no question of any decision of this panel serving to "abrogate" or "dismantle" government policy, which was the starting point for this particular exposition. Government policy is made, and if so desired unmade, by government, and by government alone. We fail to see that ATLA, as an independent statutory tribunal commanded to referee licensing disputes,

has anything to do with it, much less necessarily to inform its decisions upon what members of any particular tribunal may perceive to be government policy at any particular time.

110. A crucial distinction, and one which appears not to have been grasped in this case, is that an ATLA licence, like its necessary precursor the Air Operator's Certificate ('AOC'), functions as a necessary prerequisite to governmental designation, but that such designation by government does *not* automatically follow, which was one of the points specifically made in his oral response by the then Secretary for Economic Services in the Legislative Council proceedings of 29 May 1996. An ATLA licence, like an AOC, is a necessary 'building block' without which any application to fly upon a particular route immediately will founder; if a licence application be rejected, the matter goes no further. That which an ATLA licence is not required to reflect, however, is Government policy.

111. It follows, therefore, that the 'one route, one airline' argument, which is mounted in this case in addition to the argument on primary jurisdiction, in our judgment fails, and fails clearly.

112. As an incidental postscript — and, we hope, as pure happenstance — on the day prior to the conclusion of this hearing, on 19 March 2003, the current Secretary for Economic Development and Labour gave an oral answer in the Legislative Council to a question which asked whether, in view of the growing importance and rapid expansion of the mainland aviation market, the Government would inform the Council of the action it intended to take to assist all Hong Kong airlines to have access to this market. The Secretary's response, the content of which was

placed before us during final submissions, was instructive, emphasizing Hong Kong's status as a regional aviation center and logistics hub together with the fact of steady growth in air traffic between Hong Kong and the mainland, and further noting Government's desire to expand Hong Kong's aviation network, to review air services agreements and arrangements, and to "progressively liberalise Hong Kong's air services network to enable airlines to expand services" in a market in which clearly there remains "good potential" for expansion.

113. Whilst our conclusion in this application remains untrammelled by this expression of current thought, in so far as this answer is reflective of prevailing government view it represents an interesting contemporary backdrop to the arguments advanced in this hearing, whilst as an historical footnote the content of this Legco response does little to reinforce the confident submission made on behalf of Dragonair during this hearing to the effect that 'OROA' continues to represent government policy.

Future steps

114. In the context of Dragonair's allegations as to the financial effect likely to be suffered should Cathay Pacific be permitted to enter upon the Shanghai, Beijing and Xiamen routes, we have been addressed upon various suggestions made by Cathay Pacific as to costs management and savings — including optimal aircraft and route management utilization with regard to the three routes in question, and to the operation of the balance of Dragonair's China network — which were advanced as

palliatives capable of being adopted by Dragonair management in order to lessen the financial impact of entry by Cathay Pacific onto these routes.

115. We do not intend to comment in detail upon the particular suggestions as made, save to observe that we have considered such aspects solely when they have imposed themselves directly upon the particular issues we are mandated to consider — for example the costs element involved in the planned increase in frequencies on the Shanghai and Beijing routes, which appears to have been accepted would incur direct variable cash costs of some HK$294 million per annum.

116. For the most part, however, we have taken the view that the suggestions variously made by Cathay Pacific regarding efficiency of operation by Dragonair are not matters which are, or indeed should be, within our remit. The suggestions/criticisms emanating from Cathay Pacific seem to us to be entirely issues for Dragonair management to address if and in so far as they discern validity in such observations.

Inter-airline co-operation: code sharing

117. Considerable play was made, both in the Dragonair Rebuttal Submission and during the course of the hearing, of the fact that Cathay Pacific not only presently serves mainland China by means of an "enhanced interline service" with Dragonair — which, in a practical sense, today enables a passenger in London who wishes to go to Beijing to book on a Cathay Pacific flight and to obtain at origin boarding passes and baggage tags checked through to Beijing, notwithstanding the necessity for this passenger to change planes in Hong Kong and board a Dragonair flight

for the second leg — but also that this ‘interline arrangement’, now in place for over a decade, can be converted to an “on-line” service whereby the entire journey appears with a ‘CX’ code upon computers of travel agents throughout the world.

118. This latter position could be achieved by Cathay Pacific, suggest Dragonair, by entry into a ‘code sharing’ arrangement with Dragonair between Hong Kong and mainland China, whereby Dragonair operates its metal over the desired routes but the service is sold to the public as a Cathay Pacific service. It was pointed out that by this method Cathay Pacific already serves a considerable number of major destinations throughout the world, and that this trend continues to increase, as recently illustrated by the fact that on 19 October 2002 Cathay Pacific announced an expansion of its worldwide code-sharing operations by the completion of a code sharing agreement with its OneWorld partner American Airlines.

119. Dragonair further argued that code sharing is used extensively by major airlines, within and without the current global airline alliances, and that code sharing offers to participating carriers the opportunity to expand networks without the assumption of significant financial risk; in fact, code sharing is said already to be prevalent in the mainland China aviation market, Air China, for example, having code sharing relationships with both domestic and foreign airlines.

120. Accordingly, the submission is made by Dragonair that code share arrangements constitute an effective way of providing an extremely efficient service to the public and would, in this case, serve to avoid the ‘uneconomical overlapping’ with existing services and operators which it

is maintained necessarily will occur should Cathay Pacific be successful in this application.

121. It may be, we know not, that the possibilities of developing code sharing were at one stage regarded as worthy of further consideration by Cathay Pacific, and perhaps may have underpinned the joint application made by Cathay Pacific and Dragonair on 15 January 2003 to adjourn this inquiry. Whatever the situation as it then was, however, Cathay Pacific's position at this hearing has been unequivocally to set its face against such a proposal.

122. The essence of the opposition to a code sharing arrangement with Dragonair as a way out of the present impasse, as Mr Tyler explained it, is that the revenue which Cathay Pacific would have to pay to Dragonair on the 'prorate', that is, the 'prorated by distance' fare relating to the part of the route on which Dragonair would be the actual carrier, would be unacceptably high and would not make commercial sense to Cathay Pacific; as Mr Tyler observed: "Code sharing is a commercial arrangement. If you cannot sell a code share because the prorates that you are being given are not competitive, then there is no point in going to the expense and trouble of setting it up if you know that it is not going to work."

123. We accept this evidence. Whilst from Dragonair's viewpoint code sharing clearly represents an attractive option, equally clearly this rosy view is not shared by Cathay Pacific, and that without entry into a code share on the basis of that which Mr Tyler referred to as "straight rate prorate arrangements on [Dragonair's] domestic network in China",

the evidence is that the commercial scales regarding any code sharing arrangement would be regarded by Cathay Pacific as being tipped heavily in Dragonair's favour, and as such unacceptable.

124. Accordingly, given that code sharing is an arrangement which clearly has to work, and be seen to work, from the viewpoint of both carriers, we are unable to accept the thesis that the present dispute should be resolved on this alternative basis, nor indeed that code sharing would provide Cathay Pacific with 'on-line' benefits "more completely and efficiently than operating its own aircraft", which is the Dragonair contention.

Proposed licence conditions

125. In his final submissions to the tribunal Mr Hoo made it clear on behalf of his client that he resisted the grant of any licence to the applicant to enter upon the three routes in issue. He further argued, however, that *if* the tribunal were to countenance the application and was minded to grant a licence in some form, nevertheless such licence should be subject to conditions, in part at least to reflect the financial difficulties under which Dragonair consequently would labour. On this aspect he took two points, one substantive and one temporal.

126. We take the latter first. It was submitted that any licence to be granted to Cathay Pacific to operate on all or any of the routes for which it now has applied should be subject to a condition to be imposed that any such licence should not be effective until 2005 (the year in which, we note in passing, Dragonair's current licence to operate on mainland

routes expires). Such deferral, said Mr Hoo, would be consistent with Cathay Pacific's stated position that, were a licence to be granted, self-evidently there would be a delay in Cathay Pacific's start-up date for services on these routes, and second, that such a restriction would allow Dragonair time to prepare for the significant impact of Cathay Pacific's introduction of new services and the resultant additional capacity on these routes.

127. We do not consider that any licence to be granted should be thus restricted. Having come to the view that the applicant has successfully made out a case pursuant to the requirements of Regulation 11 — a conclusion in itself involving consideration of Dragonair's substantive case as to potential financial disaster — we see no reason now to prescribe any such limitation as to commencement date. As was implicitly recognized, given the nature of the entire process, from grant of AOC to allocation of traffic rights, inevitably there will be a period of delay before Cathay Pacific metal encounters Shanghai tarmac. We know not the extent of such delay, nor do we wish to speculate, but it seems to us that both Cathay Pacific and Dragonair possess a clear appreciation of the practicalities within the overrall process in which this tribunal plays but a small part. Even in the absence of judicial challenge to the *vires* of this tribunal — which we have been told is likely to be forthcoming should we rule that we possess jurisdiction to hear this dispute — in practice undoubtedly there will be a not insubstantial 'anticipatory window' available to Dragonair.

128. In substantive terms, Mr Hoo also took strong objection to any licence as may be granted which extended to the operation of freighter

aircraft. He pointed out that in its Rebuttal Submission Dragonair had noted specifically that Cathay Pacific had not addressed the issue of pure cargo services, that Cathay Pacific had not sought to make a case for operating such services during the hearing, and nor in this context had the possibility of 'uneconomical overlapping' been explored. Accordingly, he argued, as the applicant had neither presented nor made out a case to be permitted to operate freighter aircraft on these routes, ATLA should restrict any licence to the operation solely of those passenger aircraft specified within its Submission, and that freighters should be thus proscribed.

129. This is a surprising submission. We reject it. As we have noted at the outset, the licence application as filed by Cathay Pacific specifically included both passenger and freighter aircraft. Issue was joined by the objector, by its objection of 9 September 2002, solely in terms of the passenger aircraft element of the application. During the course of this inquiry the parties engaged on this basis and on this basis alone, and to the best of our recollection no reference was made to the specific issue of freighters. The resultant 'shape' of this case was that the applicant shouldered the overall burden of satisfying the panel that it should exercise its discretion to grant a licence on these routes in terms of the application as made, whilst the objector bore the evidential burden of establishing its assertion in terms of financial consequence and 'uneconomical overlapping'. In the circumstances, therefore, we think more accurately that the boot is on the other foot, and that specific objection to the 'pure freighter' aspect of the application ought to have been taken from the outset, with issue specifically being joined thereon. The short point is that it was not.

130. Finally, in terms of potential licence conditions, it remains to mention a matter raised by the tribunal, namely a condition within any licence restricting the types of aircraft which may be employed by the applicant upon any of these three routes. This point was not a point taken in Dragonair's final submissions — in fact, these submissions referred to limiting any licence to the full range of passenger aircraft as cited in Cathay Pacific's Submission — although Mr Hoo did adopt the point as mooted that 747 jets could be excluded from these routes. On reflection, however, and having heard Mr Haddon-Cave, we consider the point to be less attractive than it had appeared at first blush. Not only are such jets currently in use by counterpart mainland carriers, but we have been convinced that any restriction upon aircraft type on these main routes has the potential to cause unwarranted operational difficulties.

131. Any licence to be granted, therefore, will contain none of the conditions as were canvassed before us.

Jurisdiction

132. We turn now to the arguments of Dragonair relating to the primary issue of the jurisdiction, or *vires*, of this tribunal to entertain a dispute which, self-evidently, has resulted in huge expense to these parties in terms both of money and of executive time.

133. Mr Hoo has made it clear that the jurisdiction point is considered by his clients to be of fundamental import; perhaps a measure of the significance attributed to it may be divined from the application made at the beginning of the opening day of this inquiry to treat 'the Basic

Law point' as a preliminary issue, the refusal of this application occasioning at the close of that first day an unsuccessful application to the High Court for judicial review of that procedural ruling. In the event, consistent with our view that the question of jurisdiction should be dealt with as part of the general issue, we now consider the substance of the argument.

134. The submission advanced is far-reaching; if correct, it would have a fundamental effect upon the manner in which ATLA approaches its statutory obligations under the existing legislation.

135. The argument advanced is also complex, and it may assist immediately to identify the position that Dragonair desires this tribunal to reach. It is this. It is accepted that ATLA indeed possesses jurisdiction to issue a licence in terms of the Hong Kong/Beijing route, but it is *not* accepted that there is jurisdiction to consider, and if appropriate, to grant a licence in terms of the Hong Kong/Shanghai and Hong Kong/Xiamen routes.

136. The foundation for this proposition ultimately is to be found in the distinction between international routes on the one hand and domestic routes on the other. Hitherto, Mr Hoo submitted, the exercise of ATLA's power had always been related to international routes; the reason for this was clear, he said, since prior to 1997 there were no 'domestic' routes outbound from Hong Kong.

137. The grant of licences for international routes is governed by air services agreements entered into between governments, and within the

international context Dragonair accepts that the position of ATLA today remains unchanged within that hierarchy of decisions which require to be made before an airline actually begins to operate upon any such international route. Such decision-making involves that which traditionally has been understood as a 'four step' process : first, the technical evaluation involving the grant of an air operator's certificate; second, consideration by ATLA of the statutory requirements underpinning the grant of a licence to fly that route; third, governmental designation of the relevant airline pursuant to the relevant bilateral air services agreement such as is in place; and fourth, obtaining an operating permit and provision of landing 'slots' within the airport at the place of destination.

138. It was submitted, however, that this traditional procedure and approach had no place within the present dispute, given that after 1997 Hong Kong is part of "one sovereign airspace", and thus the routes the subject of the present application now must be considered as mainland *domestic* routes. In this instance, it was said, that which was required to be looked at were not inter-governmental air services agreements, but the air services arrangement which had been put in place by the Hong Kong SAR Government with the mainland authorities, an arrangement which fell solely within the purview of the Central People's Government.

139. We pause at this juncture to note that the details of the air services arrangement entered into between the SAR Government and the Central People's Government are enshrined in various confidential Memoranda of Understanding, the content of which have never been placed within the public domain. This aspect of the case led to

intervention by the SAR Government in this inquiry, in the person of Mr Reyes SC, to apply to uphold the confidential status of these documents, an application to which the tribunal acceded. In turn this caused two very brief interruptions in the public character of this hearing to enable reference to be made by counsel to the content of these confidential memoranda; in total less than half an hour was taken up with these proceedings continuing *in camera*. It was also anticipated, no doubt, that this confidentiality aspect raised a like difficulty in terms of the decision of this tribunal. Happily the issue was able to be resolved between leading counsel; agreement was reached that the primary jurisdictional argument could take place on the basis of agreed assumptions upon which this tribunal would be invited to proceed.

140. Accordingly, the tribunal has been asked to work on the *assumed* basis that in terms of the existing air services arrangement as it relates to the Hong Kong/Shanghai and Hong Kong/Xiamen routes, *one* airline only is able to be designated by the Hong Kong Government to fly on these routes, that *two* Hong Kong airlines can be so designated to operate on the Hong Kong/Beijing route, and that it is Dragonair that presently has been so designated by the Government as the Hong Kong airline to fly upon all three such routes. We are content to proceed on this basis.

141. Returning, therefore, to the substance of the jurisdictional argument, two fundamental propositions were invoked : first, that this tribunal specifically must have regard to, and was bound by, the assumed fact that under the relevant air services arrangement but *one airline* can be, and is, designated for the Shanghai and Xiamen routes, that the airline so

designated is Dragonair, and that in light of this situation ATLA should not even be considering the application so far as it related to Shanghai and Xiamen; second, and concomitantly, that if and in so far as ATLA purported to grant a licence to fly on the Shanghai and Xiamen routes — assumed already to have been subject to exclusive designation — such grant would be *ultra vires* such powers as ATLA possessed.

142. This latter proposition had as its origin the provisions of the Basic Law. The starting point here was *Article 131*, which reads :

> "The Central People's Government shall, in consultation with the Government of the Hong Kong Special Administrative Region, make arrangements providing air services between the Region and other parts of the People's Republic of China for airlines incorporated in the Hong Kong Special Administrative Region and having their principal place of business in Hong Kong and other airlines of the People's Republic of China."

143. Important to note here, said Mr Hoo, was the use of the words "in consultation with" the SAR Government, in contradistinction to the use of the term "negotiate" as employed in *Article 133*, which dealt with the unquestioned authority therein delegated to the SAR Government under the Basic Law to "negotiate and conclude" air services agreements and provisional arrangements with foreign states and regions.

144. The position changed, he argued, when it came to considering the "extremely important" *Article 134*, the terms of which state :

> "The Central People's Government shall give the Government of the Hong Kong Special Administrative Region the authority to :
>
> (1) negotiate and conclude with other authorities all arrangements concerning the implementation of the air

> services agreements and provisional arrangements referred to in Article 133 of this Law;
>
> (2) issue licences to airlines incorporated in the Hong Kong Special Administrative Region and having their principal place of business in Hong Kong;
>
> (3) designate such airlines under the air service arrangements and provisional arrangements referred to in Article 133 of this Law; and
>
> (4) issue permits to foreign airlines for services other than those to, from or through the mainland of China."

145. It was apparent, Mr Hoo submitted, that in contrast to the 'wholesale delegation of authority' from the Central People's Government to the SAR Government for international agreements and provisional arrangements, there was clearly no delegation by the Central People's Government to the Hong Kong SAR Government of the right to *designate* carriers for domestic routes covered by Article 131. It followed, therefore, that since there was no delegation of any such right, the generally-accepted 'four step' procedure simply did not apply to domestic routes within the PRC, and that so far as ATLA was concerned, when dealing with such routes, ATLA was in the position merely of implementing such arrangement as currently existed.

146. Accordingly, he submitted, when one is talking about the regime as it concerns domestic routes, the *first* point of inquiry has to be the air services arrangement currently in place. In this case, therefore, applications in this matter for an additional carrier for routes to Shanghai and Xiamen should not even be on the table; on the assumed basis that the relevant arrangement provided for but one carrier on those routes, "the rights for which the licences under this application are being sought are

already defined and in operation". Contrast the position of the Beijing route, said Mr Hoo, with regard to which no jurisdictional point was asserted, although clearly that element of the present application still had to pass the Regulation 11 threshold.

147. The bald proposition advanced, therefore, is that ATLA can *only* exercise its powers in accordance with the air services arrangement regarding any such route or routes as such arrangement exists at that time. This submission was buttressed by the additional submission that not only was the present process clearly futile, but that should ATLA purport to grant the licences as now were sought, political damage inevitably would be caused. The objective behind the delegation of authority to issue licences on domestic routes was simply to implement the existing arrangement, it was asserted, and if this arrangement was now to be disregarded, in so doing ATLA would "undermine the authority and the national policy for domestic aviation of the Central People's Government", for whom it would be "a slap in the face if ATLA were to issue licences to cities in mainland China in clear contravention of the arrangements".

148. In addition, it was submitted that the relationship between the Hong Kong SAR Government and the Central People's Government would also be "undermined" because the authority to issue licences has been delegated to the SAR Government, and not to ATLA. The SAR Government had been party to the creation of the air services arrangement so that "a situation has been achieved through the consultation process of equilibrium and reciprocity", and naturally it was expected that the Hong Kong Government would act with bona fides and credibility and with the responsibility to abide by "the integrity of the arrangements". Moreover,

equal treatment having been achieved on these routes through consultation, "equilibrium would be threatened" and it would, in Mr Hoo's words, "definitely send the wrong signal to the Central People's Government and the mainland carriers, if ATLA were to issue licences to Shanghai and Xiamen, that the Hong Kong SAR Government is not keeping its word."

149. We confess that we had not appreciated, in simply fulfilling the established statutory function of hearing a disputed licensing application, that we should find ourselves in such an apparently invidious position. Suffice to say that we do not consider well-founded Dragonair's evident concern that we are causing or will cause "harm" in dealing with the application for licensing upon all three of these routes.

150. To the contrary, in considering the application before us we intend to, and send, no political signals whatever, nor do we seek to threaten any "equilibrium", political or otherwise, and (perhaps most important) we do *not* accept that the grant of any licence will be regarded as offensive or will in some manner detract from the integrity of the present air services arrangement, an arrangement which in any event is subject to inter-governmental review and amendment from time to time. We say again that all that the present process involves (and should involve) is the vetting, against established statutory criteria, of the merits of a particular licence application, and that the only 'signal' to be sent as the result of such process is a signal to the Hong Kong Government that the application has been evaluated in terms of the benchmark requirements of Regulation 11, and either that it has been granted, or that it has not. We therefore unequivocally reject those parts of Mr Hoo's submissions which are collateral to the issue of jurisdiction in itself.

151. Jurisdiction is a concept of fundamental importance. Either it exists or it does not. There is no half-way house and, it seems to us, its existence is not lightly questioned. It follows that we have accorded the most serious consideration to the submission that we are acting *ultra vires* in purporting to deal with the present application in so far as it relates to the Shanghai and Xiamen routes.

152. We naturally accept the proposition that the authority of ATLA, as an independent statutory body established by the Hong Kong Government, cannot exceed the authority of the Government itself under the Basic Law. In this instance, however, we do not accept that the terms of *Article 134(2)* of the Basic Law permit of any doubt. In our view there is no question of this Article requiring interpretation, whether by the courts or, as Mr Hoo so clearly flagged in this context, exclusively by the Standing Committee of the National People's Congress.

153. *Article 134(2)* is crystal clear. It means precisely what it says. The Central People's Government "shall" grant to the SAR Government the authority to issue licences to airlines incorporated in and having their principal place of business in the SAR. We are unable to see that the Dragonair argument, creatively-fashioned and fluently expressed, regarding the alleged absence of authority delegated to the SAR Government to *designate* airlines on domestic routes, can be of consequence in terms of the separate licensing function with which we are seized, nor why this argument should be thought to affect the 'traditional' role which ATLA plays, and has always played, within the process by which airlines are licensed to fly on any given route.

154. We repeat our view that such political considerations as may be involved in the *designation* of airlines to fly on certain routes fall solely within the realm of inter-governmental concerns, as reflected by the holding of annual meetings between representatives of the two governments to deal precisely with such concerns. We note that on 19 March 2003 the Secretary for Economic Development and Labour stated in the Legislative Council that since 2001 there has been annual discussion with the mainland aviation authority, CAAC, as to the expansion of the air services arrangement "resulting in an increase in the number of routes and capacity that airlines of both sides can operate", and that "when discussing expansion of our arrangement with the mainland authorities, it has been our objective to progressively expand traffic rights for both sides."

155. It seems to us, with respect, that the fact that such traffic rights may, or may not, be thus expanded or amended is entirely an issue for the two governments to discuss and, if thought appropriate, on which to agree or disagree. We reject the suggestion, in effect, that *until* such inter-governmental agreement takes place to vary any arrangement providing for but one Hong Kong carrier upon a particular route that ATLA's essentially secondary function to oversee the grant of a licence for a proposed service on that route thereby is rendered nugatory by reason of lack of jurisdiction.

156. We have concluded, therefore, that the jurisdictional argument advanced to this tribunal lacks substance, and we reject it. We have taken the view that our consideration of the present disputed licence application

is not *ultra vires* and falls entirely within the jurisdiction of ATLA as presently statutorily constituted.

157. If we may say so, in terms of the grant of licences by ATLA the Dragonair position as to jurisdiction appears to lack a certain consistency. The unvarnished fact is that Dragonair's current licence, as granted by ATLA in March 2000, to operate on mainland routes covers a total of 48 points, and is valid from 1 April 2000 to 31 March 2005. Out of these 48 points, routes to only 19 of these cities currently are in operation. Nevertheless, the current Mainland/HKSAR air services arrangement, signed and in force as from 2 February 2002, covers less than all of these 48 mainland points. The position, therefore, is that Dragonair currently is licensed to fly to a number of points which are *not* covered in the current air services arrangement, although as we understand it there is no suggestion that the ATLA licence regarding these points is, or thereby has been, rendered invalid.

Decision

158. We have not found this an easy case. Not only are bifurcated hearings difficult by their very nature, but we are conscious of the danger of our perception being obscured by the blizzard of data placed before us. That said, we are obliged to leading counsel and their teams for their assistance.

159. Upon careful review of the entirety of the evidence before us, we have concluded that the applicant, Cathay Pacific, has discharged the

burden upon it of persuading the tribunal, in its discretion, to grant a licence to operate upon the Shanghai, Beijing and Xiamen routes.

160. The aspect of the matter which has caused us significant additional concern, however, is the frequency of flights to be permitted within such proposed route operation. We earlier have noted that whilst the application itself formally requested the grant of a licence providing for "unlimited frequencies in each direction", the case itself has been fought upon the basis of daily frequencies of 4/3/1 to Shanghai, Beijing and Xiamen respectively, and we have framed our deliberations upon this basis. Certainly at this stage we are unable to approve a licence on the basis of the "unlimited frequencies" posited in the licence application.

161. We bear in mind that in proposing these frequencies, the aim of the applicant, in terms of the Shanghai and Beijing routes at least, has been to construct inbound and outbound 'waves' of operation throughout the day. We also have reflected at length upon the economic data relating to these two routes, together with the daily operations of the counterpart carriers thereon.

162. Taking these factors into account, we have decided that Cathay Pacific should be licensed to fly upon the Hong Kong/Shanghai and the Hong Kong/Beijing routes for a period of five years, and that such licence should be restricted to frequencies upon each route of three flights per day.

163. The issue of the Xiamen route is in our view less clear cut, and we have approached this aspect with some reservation. In fact, it is

probably not unfair to say that in the cut and thrust of debate the Xiamen element of the application tended to be overshadowed, although perhaps that is understandable in terms of the relative difference in revenue and passenger volumes. We wonder, too, whether this element of the application had at least as much to do with the presence at Xiamen of Cathay Pacific aircraft maintenance facilities as to the attractiveness of this route *per se*.

164. Be that as it may. After a significant degree of hesitation, not least because of the considerable implications for the Xiamen route should current restrictions upon mainland/Taiwan direct air links become increasingly relaxed, we have concluded that Cathay Pacific should be licensed to enter upon this route for a like period of five years, but upon a frequency basis of flights restricted to three times per week. The licence as granted will reflect that fact.

165. In deciding as we have on this application we recognize that we have erred on the side of caution, and that if and in so far as the Chinese aviation market continues to demonstrate the rapidity of expansion which has characterised its development within the past several years that the frequencies permitted under the terms of the licence as now granted may require revisiting. In that event, it is clearly open to the applicant to make a further licence application to ATLA, by which stage any tribunal seized with the issue would have the signal benefit of hard historical data in terms of passengers and load factors carried on these routes, as compared with the mere extrapolations with which we have had to contend in this inquiry.

166. For the present, however, these are the conclusions which commend themselves to us.

Postscript : Severe Acute Respiratory Syndrome ('SARS')

167. As we were in the process of completing this Decision, we received a letter dated 7 April 2003 from the solicitors acting for Dragonair. An enclosure to this letter, to which our attention was directed, made representations that "if appropriate" the tribunal should consider the "immediate effect" of the current SARS outbreak on Dragonair's route profitability, in particular on the Shanghai, Beijing and Xiamen routes, given sharply reduced passenger demand and consequent reduction in frequencies both on these routes and also on its secondary network, wherein flights to some destinations have been suspended. It is said that the impact of SARS has "nullified" the traffic forecasts as given in the hearing of the Cathay Pacific application, and that there is now "no scope" for licensing another operator on these routes "at this time or in the immediate future."

168. The response of the solicitors acting for Cathay Pacific has been that this letter, together with its unsigned and undated enclosure, is inadmissible and should be ignored.

169. We do not wish to take an overly legalistic stance, and we refer to this letter, and its enclosure, as a matter of record.

170. Naturally we are aware of the difficulties encountered by *all* airlines, and indeed the entire travel industry generally, consequent upon

the recent SARS epidemic in southern China and Hong Kong. Whilst extremely unfortunate, and painful to every carrier in the region in terms of acute short term dimunition in passenger loads and revenue, we do not consider that this phenomenon is something that will alter the permanent face of aviation in China and Hong Kong, nor do we think that the current highly abnormal situation should impact upon the decision we otherwise have taken in this case.

171. In the circumstances we adhere to established principle. We do not decide this dispute on any basis other than upon the evidence as it was adduced before us at the hearing of this application.

(signed)	*(signed)*	*(signed)*
Hon Mr Justice Stone (Chairman)	Mr Almon C.H. Poon JP	Mrs Fanny P Lai

ATLA Secretariat
April 17 2003

Appearances

Mr Charles Haddon-Cave QC, instructed by Messrs Johnson, Stokes and Master, for the Applicant, Cathay Pacific Airways Limited

Mr Alan Hoo SC and Miss Catrina Lam, instructed by Messrs Clyde & Co. (from 23 January-29 January 2003); Mr Alan Hoo SC, Mr Hectar Pun and Miss Catrina Lam, instructed by Messrs Lau Chan & Ko (from 11 March-20 March 2003) for the Objector, Hong Kong Dragon Airlines Limited

Mr Anselmo Reyes SC, instructed by the Department of Justice on behalf of the Economic Development and Labour Bureau, Hong Kong SAR Government

In attendance

Miss Sandy Chan, Principal Assistant Secretary for Economic Development and Labour (Economic Development), for ATLA Secretariat