

We welcome your views

This Consultation Document on Partial Privatization of the Airport Authority seeks the community's views on the regulatory and institutional framework pertinent to the proposed partial privatization of the Airport Authority.

The Administration has set out some preliminary proposals. You are welcome to let us have your comments on these proposals before 28 February 2005*. You may send your comments to :

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The full text of this Consultation Document is also available at www.edlb.gov.hk/edb/eng/papers/cdoc/.

Economic Development and Labour Bureau
November 2004

* The consultation period has been extended to 31 May 2005.

Consultation Document on Partial Privatization of the Airport Authority

Introduction

This paper sets out the key issues on the regulatory and institutional framework pertinent to the proposed partial privatization of the Airport Authority (AA) for further consultation with stakeholders and members of the public.

Background

2. On 6 August 2003, the Government announced its plan to commence work in preparation for the proposed privatization of AA. The Government hopes that privatization will help strengthen AA's market discipline in the running of the airport for greater efficiency and more commercial opportunities. It will also introduce an additional quality stock to our financial market and enable Hong Kong people to own shares in our successful airport. In addition, proceeds from sale of shares in AA would bring capital revenue to the Government in the medium term.

3. The Government has since engaged an investment bank as its financial advisor to examine the privatization proposal in consultation with AA and other stakeholders. Generally speaking, most stakeholders expressed support for the objective of privatization, but many pointed out that AA would have to demonstrate a reasonable business case in order to attract potential investors. They also emphasized the need to address a number of regulatory issues in order to safeguard public interest in the operation and development of the Hong Kong International Airport (HKIA) after privatization.

4. In February 2004, the Government briefed the Legislative Council on its plan to proceed with the privatization exercise on the basis of an initial public offering (IPO). We also indicated that we will further consult stakeholders including AA on the specific issues before finalizing the legislative proposals together with other regulatory documentation.

Since then, the Government took steps to enhance AA's capital structure by reducing its equity capital and hence optimizing its debt to equity ratio. In June 2004, the Legislative Council passed the Airport Authority (Amendment) Bill 2004 and a Resolution to authorize AA's return of \$6 billion equity capital to the Government.

5. In parallel, we continue to examine other matters relating to the privatization of AA. Taking into account comments received during the earlier consultation, we have set out in this paper some specific issues on which we would like to obtain further feedback. In considering these issues, it would be necessary to strike a balance between competing and sometimes conflicting considerations. For example, while the Government would need to retain certain powers over the privatized AA (the new Company) in order to safeguard public interest, potential investors including members of the public would expect it to be able to operate commercially with as little Government or political intervention as possible. There are other competing considerations and some of the proposals set out in this paper aim to strike a reasonable balance. These proposals are by no means the final position of the Government. A final decision will be taken only after we have obtained further feedback.

Relationship between the Government and the new Company

6. AA is currently a statutory corporation set up under the AA Ordinance (Cap. 483) to provide, operate, develop and maintain the HKIA with the objective of maintaining Hong Kong's status as a centre of international and regional aviation. While it is wholly owned by the Government and all members of its Board are appointed by the Chief Executive, AA is required by statute to conduct its business according to prudent commercial principles.

7. To enable AA to be privatized by means of an IPO, a new company will need to be formed under the Companies Ordinance (Cap. 32). All the assets, properties, rights and obligations of AA will be vested in the new Company by statute. This will repeal the existing AA Ordinance and will, together with other legislation including the Civil Aviation Ordinance (Cap. 448) and Air Navigation (Hong Kong) Order 1995, set out the regulatory framework after the new Company is duly

constituted. After this corporatization process, the Government intends to dispose of part of its shares in the new Company through an IPO and list the new Company on the Hong Kong Stock Exchange. At the same time, the Government will retain appropriate powers over the new Company to ensure safe and efficient operation of the airport, and compliance with our obligations under the Basic Law¹ and other international treaties relating to civil aviation applicable to Hong Kong.

8. While the Government will continue to be the majority shareholder of the new Company in the foreseeable future, the Government will also play the role of a regulator and ensure that public interest is safeguarded in the development and operation of the airport. During the earlier consultation, some people pointed out that it would be necessary to clearly prescribe the different roles of the Government as a shareholder and the regulator. In particular, the Government's regulatory powers over the new Company should be clearly set out to ensure that the Government would not force it to undertake commercially unviable projects and that the interests of minority shareholders would be protected.

9. In addition, given its role as the regulator, the Government has to retain adequate powers over the new Company in order to safeguard public interests. We set out below the more important regulatory controls over the new Company that we are considering-

¹ The Basic Law provisions directly relevant to airport operations, with our own emphasis underlined, are –

Article 128 : 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.

Article 129 : The Hong Kong Special Administrative Region shall continue the previous system of civil aviation management in Hong Kong and keep its own aircraft register in accordance with provisions laid down by the Central People's Government concerning nationality marks and registration marks of aircraft.....

Article 130 : The Hong Kong Special Administrative Region shall be responsible on its own for matters of routine business and technical management of civil aviation, including the management of airports, the provision of air traffic services within the flight information region of the Hong Kong Special Administrative Region, and the discharge of other responsibilities allocated to it under the regional air navigation procedures of the International Civil Aviation Organization.

- (i) As a guiding principle, *it is proposed that the legislative proposals should contain sufficient powers for the Government to exercise various regulatory functions, notwithstanding the Government's current intention to remain as a majority owner of the new Company in the foreseeable future.* This would enable the Government to effectively discharge its regulator's functions.
- (ii) *It is proposed that the Government should be empowered to appoint a minority number of additional members to the Board of the new Company to represent the Government or the public interests, on top of any rights the Government may have as a shareholder.* The purpose is to ensure that apart from their fiduciary duty to the new Company, these additional Board members are legally empowered to advocate viewpoints on public policy grounds. As these directors will be in the minority, they would help ensure that the Board would carefully consider these viewpoints without pre-empting the Board's commercial decisions.
- (iii) *It is proposed that more than half of the members of the new Company's Board, excluding the additional directors appointed by the Government, should be ordinarily resident in Hong Kong, and that the existing requirement for the AA Chairman to be a Hong Kong Permanent Resident should be retained.* These requirements would help ensure that the strategic airport facility will continue to be managed by predominantly Hong Kong residents.
- (iv) *It is proposed that exercise of voting rights by any single shareholder (including associates), other than the Government, should be limited to not more than 10% of the total voting rights of all shareholders.* This would help prevent any single investor from having overwhelming influence on its operations and future development. There are similar restrictions in respect of some other privatized airports elsewhere.

- (v) ***It is proposed that the exercise of voting rights in the aggregate by shareholders who are not ordinarily resident in Hong Kong should be limited to not more than 49% of votes cast at a general meeting of shareholders.*** This restriction would ensure that persons who are not ordinarily resident in Hong Kong would not be able to force a resolution at a general meeting of shareholders. Similar provisions exist in the Broadcasting Ordinance (Cap. 562) and Telecommunications Ordinance (Cap. 106) in relation to broadcasting companies, and in overseas legislation governing some other privatized airports.
- (vi) ***It is proposed that the Government should be empowered to obtain information from the new Company for the purpose of enforcing relevant laws and regulations.*** Similar power exists in the present AA Ordinance, and serves to facilitate effective regulation by the Government.
- (vii) The Government would need to be satisfied that the new Company would continue to invest in the HKIA to meet demand. ***It is proposed that the new Company would be required to submit capital investment plans to the Government as a regulator of the airport for information.*** With such an arrangement, the Government would be able to initiate discussion with the new Company early if there are any deficiencies in the plans. There has been suggestion that these capital investment plans should be subject to approval by the Government. This is not supported as it may be perceived by investors as giving the Government too wide a power to influence the new Company's commercial decisions in respect of its investment.
- (viii) ***It is proposed that the Government should be empowered to give directions to the new Company in the public interest, with compensation to it under specified circumstances.*** Similar provision exists in the present AA Ordinance, and serves as a means to enable the Government to intervene in the AA's action to safeguard public interest. A

compensation mechanism is provided to protect the commercial interest of AA in case it is directed to act contrary to prudent commercial principles and thereby suffers financial loss through no fault of its own.

- (ix) *It is proposed that the Government should be empowered to take over the new Company's assets in case of the new Company's default or under emergency situation, with compensation to the new Company under specified circumstances.* This is the ultimate safeguard of public interest and would enable the Government or its designated third party to maintain the operations of the airport in case of default by the new Company or under emergency situation. The provision would also ensure that there is no unfair expropriation of private property.
- (x) *It is proposed that the Government should be empowered to impose financial penalties on the new Company for breaches of relevant laws and licensing conditions; and should retain powers to suspend or revoke the aerodrome licence of the new Company in justifiable cases such as substantial breakdown of services at the airport.* These are essential to ensure that the new Company would maintain suitable standards in operating HKIA.

AA's Business Case and Valuation

10. Since establishment and development of an airport requires very capital-intensive infrastructure, and capacity has to be built in advance of utilization, it normally takes a relatively long time to achieve a reasonable return on investment. Compared to Government's equity injection of \$30.7 billion (about \$36.7 billion before capital restructuring), AA's \$502 million profit in 2002-03, which was the highest so far, represents a return on equity of less than 2%. This is far lower than what would be considered reasonable from a commercial perspective.

11. With the strong economic recovery of Hong Kong in recent months and continued growth in tourist number, HKIA has already

recorded significant growth in both passenger and cargo traffic in the current financial year. AA forecasts that the growth will continue to be robust and that its return will improve. Notwithstanding this positive outlook, AA's currently low profitability means that it would unlikely achieve a reasonable commercial return in the next few years without substantially increasing its revenues and lowering its costs.

12. Prior to IPO, AA is expected to demonstrate to potential investors that it would be able to achieve a commercial return within a reasonable period of time. Otherwise the market would unlikely support a valuation that is comparable to the \$30.7 billion of taxpayers' investment in it. AA has already embarked on a number of cost cutting measures while trying their best to maintain high service standards at the airport. It has also striven to increase its commercial revenues, which are already relatively high among comparable airports and account for about 50% of AA's total income. As airport charges (currently comprising landing, parking and terminal building charges levied on airlines in respect of their aeronautical activities) account for about 45% of AA's total revenues, AA would also need to consider increasing such charges if it were to achieve a reasonable return in the next few years.

13. The actual level of increase in airport charges required before the market would value it in the region of \$30.7 billion depends on many factors including AA's business performance prior to IPO, the design of the regulatory framework, and market conditions. From the capital market point of view, it would be ideal if any proposed increase in airport charges in the initial years after privatization (or "the glide path") could be determined prior to IPO to provide better transparency and certainty.

14. Such increases in airport charges would unlikely be well-received by airlines. They argue that the airport is a public infrastructure and a long term investment. The Government should not seek to obtain a commercial return from it shortly after its opening. According to airlines, such increases in airport charges would make our airport less competitive, particularly in the light of increasing competition from other airports in the region, such as Guangzhou, Singapore and Bangkok.

15. On the other hand, it is worth noting that as an international average, airport charges account for only about 4% of the operating costs of airlines. Airport charges paid by two local airlines to AA (i.e. excluding payment to other airports) in 2003 range from 2.6% to 4.0% of their total operating costs. Normally, airlines respond to passenger and cargo demand and there is no strong evidence to suggest that the level of airport charges will sway airlines' choice of destinations. Furthermore, within the region, our current airport charges are comparable to the level in Singapore and lower than those in Seoul, Bangkok, Taipei and the Mainland of China. AA therefore holds the view that some increases in airport charges will have little impact on HKIA's competitiveness.

16. In the final analysis, the question is whether the costs of constructing and running the airport should be fully recovered from its users in the long run. It is a choice between securing a better valuation at IPO by increasing airport charges in the next few years, or keeping airport charges more competitive at the risk of undermining the valuation at IPO, thereby diminishing taxpayers' investment in AA. This is a difficult choice we have to make.

17. We have not come to a decision on this particular issue. You are invited to indicate your views on the following questions-

- (xi) ***Do you consider it essential to preserve taxpayers' \$30.7 billion investment in AA in the privatization exercise; and if so, do you consider it reasonable and acceptable to increase airport charges over a period of three to five years in order to achieve this?***

- (xii) ***Do you attach more importance to minimizing any increase in the airport charges in the next few years; and if so, do you consider it acceptable if taxpayers' investment in AA as measured by its valuation at IPO is diminished?***

Economic Regulation

18. It is envisaged that at the end of the initial period where airport charges are set out in the “glide path” mentioned above, the new Company’s return would have improved to a more reasonable level through gradual increases in airport charges and growth in air traffic. In subsequent years, a more transparent and objective mechanism would be required for determination of airport charges. An economic regulatory mechanism should provide a predictable and equitable charging regime catering to the long term needs of the HKIA.

19. At present, AA has autonomy in setting its airport charges, subject to the Chief Executive in Council’s prior approval. The scope of scrutiny in this process is limited. The AA Ordinance stipulates that the Chief Executive in Council shall approve the proposed scheme unless he considers that implementation of the scheme would, or would be likely to, result in a breach of an international obligation relating to civil aviation or hindrance of the implementation of such an obligation.

20. While some quarters have suggested that being a listed company, the new Company should continue to enjoy autonomy in setting airport charges, many others suggested that there should be a defined mechanism to govern the adjustment of airport charges to prevent the new Company from abusing its market power and extracting undue benefits from airlines.

21. On balance, we consider it desirable to set out a transparent regulatory framework for the determination of airport charges given that HKIA is the only international airport in Hong Kong. However, in designing the regulatory framework, it is important to ensure that sufficient commercial flexibility and incentive be retained to enable the new Company to maintain high quality services and operate successfully as a listed company. Furthermore, a regulatory framework which prohibits the new Company from earning a reasonable return over the long term would undermine the market’s valuation, making it more difficult to recoup taxpayers’ investment in AA through the privatization.

22. Against these considerations, we are putting forward the following issues for further consultation-

- (xiii) There has been general support for an economic regulatory framework that is fair, predictable, transparent and simple to administer. ***It is proposed that the regulatory framework should also subscribe to the user pays principle; allow the new Company a reasonable return on its investment; and provide incentives for enhancing efficiency and increasing capacity to cater for demand.***

- (xiv) ***It is proposed that only airport charges (i.e. currently landing, parking and terminal building charges) paid by airlines should be regulated,*** as they concern those core airport activities which are necessary for the operation of the airport, but cannot be economically duplicated or produced outside the airport perimeter. This would avoid over-regulation and is in line with the practice in most other privatized international airports. Some airlines have suggested that the airport should adopt a so-called “single-till” approach where the profits from both aeronautical and commercial activities should be taken together in calculation of the target return, so that the profits from the new Company’s commercial activities could contribute towards keeping airport charges more competitive. We consider the currently proposed arrangement a better alternative because excluding commercial revenues from the regulatory framework should offer more incentive for the new Company to explore commercial opportunities. Making the aeronautical operations a commercially viable business on its own would also better encourage the new Company to maintain its aeronautical services at high standards. The objective of keeping airport charges competitive will be achieved through setting a lower target return for its regulated activities as per item (xv) below.

- (xv) In line with the user pays principle and to ensure adequate investment in new facilities, the new Company would need

to have a reasonable return on its aeronautical activities. But in view of the importance of maintaining the competitiveness of the airport, *it is proposed that the level of the new Company's target return for aeronautical activities should commensurate with the risk of the aeronautical business, which may not necessarily be the same as the average cost of capital of the new Company as a whole.* The exact formula for computing the target return, including the risk premium to be applied, will be determined by the Government prior to IPO after further analysis of AA's business plan.

- (xvi) *It is proposed that the new Company should be allowed to negotiate on a commercial basis with airlines' representatives on the level of airport charges every three years or as a need arises, within a set of broad parameters set out in the Ordinance.* These parameters may include references to the relative competitiveness of HKIA in the region and the general economy of Hong Kong. This would allow the new Company and primary users of HKIA to work out commercial arrangements best suited for the evolving aviation industry without unnecessary regulatory intervention.
- (xvii) There have been diverse views on how airport charges should be adjudicated in case the new Company and airlines cannot come to an agreement through commercial negotiation. *It is for consideration whether the Government or a Government appointed independent panel should be empowered to adjudicate on the reasonable level of airport charges* taking into account factors like inflation, return on investment, etc. It will also receive representations from both the new Company and airlines.
- (xviii) *It is proposed that the new Company should be required to draw up a set of service standards, and on the basis of which a financial reward and penalty system should be devised to link the actual service standards to the level of*

airport charges. A similar system is being implemented in London's Heathrow and Gatwick Airports.

Land Use, Competition and Scope of Business

23. The airport island measuring about 1,255 hectares was granted to AA in 1995 under a legally binding land lease. Most of this area is required for airport operational and support facilities. Excluding developed land, about 49 hectares of land has been earmarked for other airport-related uses such as logistics operations, offices or other commercial premises. Subject to applicable laws, restrictions in the Land Grant and other Government regulations, AA is allowed to conduct any airport-related activities on the airport island.

24. As regards activities outside the airport island, AA is at present permitted to conduct only those airport-related activities specified in the Airport Authority (Permitted Airport-related Activities) Order (Cap. 483, sub. leg.), such as alliance or cooperation with other airports; acquisition of interests in other airports in China; provision of advisory or consultancy services to another airport; and operation of carriage and logistics services. Such activities must be expedient for or conducive to the promotion or maintenance of Hong Kong's status as a centre of international and regional aviation or the competitiveness of the HKIA, and may require prior approval by the Financial Secretary if the amount involved exceeds a certain limit.

25. In the course of our informal consultation, some stakeholders expressed concern that the new Company would enjoy an edge over other private developers given the amount of land it holds on the airport island and its status as the operator of HKIA. Some people have suggested taking back all undeveloped land held by AA and re-grant individual sites to the new Company as and when necessary. Others have suggested circumscribing the range of activities which can be undertaken by the new Company to prevent unfair competition with other companies.

26. On the other hand, there was suggestion that like many airports elsewhere, the new Company should continue to hold land on the

airport island and be allowed the flexibility to plan for its use to meet airport development needs. Some people also argued that after the new Company has become a listed company, it would be unfair to its shareholders – including the investing public – if its expansion flexibility is restricted. They suggested that so long as the new Company was able to perform satisfactorily in operating HKIA, it should not be unduly restricted from undertaking other commercial activities.

27. On balance, we believe that given the strategic importance of HKIA to Hong Kong's economy, it is not unreasonable to subject the new Company to more regulatory controls. Such controls should aim to ensure that the limited land resources on the airport island are not used for purposes unrelated to airport operations, and that operations of HKIA would receive the foremost management attention. However, any such control is not intended to restrict the flexibility of the new Company in planning for further development of HKIA, or to stifle the commercial vitality of the new Company. Given the fast developing aviation industry, it is possible that the new Company would develop businesses that complement or even enhance the status of the HKIA as an international and regional aviation hub in future. But in view of concerns about possible unfair competition with other companies, consideration could be given to introducing statutory prohibition on the new Company against anti-competitive activities and abuse of its dominant position.

28. Accordingly, we are putting forward the following propositions in relation to matters discussed in this section-

- (xix) *It is proposed that the new Company should continue to hold and make use of the land on the airport island in order to retain flexibility in planning and developing necessary facilities in support of airport operations, and that the existing controls over land uses on the airport island, including limitation on AA to use the land only for airport-related purposes and the requirement for AA to obtain prior Government approval for its building plans should continue.*

- (xx) As regards activities outside the airport island, *it is proposed that the existing restrictions on the range of airport-related activities that AA may conduct should be retained.* However, in view of the status of the new Company as a listed company, it may be no longer appropriate to require the new Company to seek the Financial Secretary's prior approval for its commercial activity. *It is for consideration whether such approval requirement should be replaced by a new provision empowering the Government to direct the new Company to divest an investment or desist from undertaking an activity if it is found to be outside the range of permitted activities.*
- (xxi) *It is proposed that statutory provisions be made to prohibit the new Company from engaging in anti-competitive activities and abuse of its dominant position in relation to its land use and scope of business.* Such provisions would draw reference from similar provisions in the Telecommunications Ordinance (Cap. 106) and Broadcasting Ordinance (Cap. 562) and overseas regulation.

Impact on Companies and Workers at the Airport

29. Finally, during the earlier consultation exercise, some members of the airport community and labour organizations expressed concern about the potential adverse impact of the proposed privatization on their companies or the welfare of workers at the airport. They are worried that the new Company would become more profit oriented and exploit them whenever possible.

30. Such concerns are understandable, but in reality the privatization exercise should not cause any such adverse impact on these companies and workers. First of all, AA is already operating under prudent commercial principles as required by Section 6 of the AA Ordinance. This mode of operation would not change as a result of privatization.

31. Second, AA's established practice is to invite competitive tenders from the market for provision of services at the airport. As a general principle, the bidders' experience and service quality are the determining factors instead of pricing alone. Airport franchisees and contractors determine the wages and staffing level to ensure that the prescribed service standards are met. Again, this mode of operation would not change as a result of privatization.

32. Third, to ensure smooth and efficient operation of the airport, the new Company would continue to attach great importance to maintaining harmonious relationship with both its business partners and employees at the airport. The commercial objective of both the new Company and other operators at the airport are to maintain a highly efficient airport with a view to attracting more business opportunities.

33. Fourth, AA already has a very lean set-up with only about 900 staff. It has confirmed that it has no plan to lay off any staff or reduce their benefits as a result of privatization. After privatization, issues relating to employment of labour would continue to be governed by relevant legislation that safeguards the interests of all employees.

Views Sought

34. You are welcome to let us have your comments before 28 February 2005* on points (i) to (xxi) above, and on any other aspects of the proposed privatization of AA. Taking into account comments received, the Administration will formulate the legislative proposals for the privatization for consideration by the Legislative Council. You may send your views to-

* The consultation period has been extended to 31 May 2005.

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Views received may be made public together with the identity of the author. If you prefer to have your views reflected anonymously, please tell us when you send in your comments.

Economic Development and Labour Bureau
November 2004

Useful Reference Materials:

1. Airport Authority Ordinance (Cap. 483) <www.justice.gov.hk/eng/index.htm>
2. Paper for the meeting of the Legislative Council Panel on Economic Services held on 23 February 2004
<www.legco.gov.hk/yr03-04/english/panels/es/papers/es0223cb1-1017-5e.pdf>
3. The Administration's response to questions raised at the Legislative Council Panel meeting held on 23 February 2004
<www.legco.gov.hk/yr03-04/english/panels/es/papers/es0302cb1-1154-1e.pdf>
4. The Administration's response to questions raised at the Legislative Council Panel meeting held on 2 March 2004
<www.legco.gov.hk/yr03-04/english/panels/es/papers/es0302cb1-1749-1e.pdf>