

Introduction

This leaflet contains a summary of some key issues on the regulatory and institutional framework pertinent to the proposed partial privatization of the Airport Authority (AA) on which Government would like to obtain public feedback. You are encouraged to read the full text of the consultation paper for a full discussion of all issues and related proposals, available on:

www.edlb.gov.hk/edb/eng/papers/cdoc/

These proposals are not final. Government will formulate the legislative and regulatory framework for the privatization taking into account feedback received.

Relationship between Government and the privatized AA

AA operates Hong Kong International Airport (HKIA), a strategic asset for Hong Kong. After privatization of AA through an initial public offering (IPO), Government will need to retain appropriate powers over the privatized AA (the new Company) to ensure safe and efficient operation of the airport and compliance with our obligations under the Basic Law and other international treaties relating to civil aviation applicable to Hong Kong.

To discharge its obligations as a regulator, Government intends to retain adequate powers over the new Company. A summary of Government's current proposals and the corresponding rationale is highlighted below:

- (i) To provide adequate legal powers for Government to exercise its regulatory functions effectively.
- (ii) Regardless of its shareholding, Government to appoint a minority number of additional members to the Board of the new Company to represent the Government's public policy interest.

- (iii) To retain the existing requirement for the Chairman to be a Permanent Resident; Hong Kong residents to constitute the majority of non-Government related Board members such that this strategic facility will continue to be managed by local expertise.
- (iv) Other than the Government, to disallow any single shareholder to exercise voting rights of more than 10% of all shareholders' rights to prevent undue influence on its operations and future development.
- (v) To limit the exercise of voting rights by non-Hong Kong resident shareholders in aggregate to not more than 49%.
- (vi) To empower Government to obtain information from the new Company for the purpose of enforcing relevant laws and regulations.
- (vii) The new Company is to submit capital investment plans to the Government for information purposes.
- (viii) To empower Government to give directions to the new Company in the public interest, with compensation to the new Company under specified circumstances.
- (ix) In certain defined situations, such as under an emergency situation or default on the part of the new Company, to empower Government to take over its assets with compensation to it under specified circumstances. The takeover provision is the ultimate safeguard of public interest and the compensation provision is necessary to ensure that there is no unfair expropriation of private property.
- (x) To introduce financial penalties on the new Company for breaches of relevant laws and licensing conditions and to retain powers for Government to suspend or revoke the aerodrome licence of the new Company in

justifiable cases, e.g. substantial breakdown of services at the airport. These are essential to ensure that the new Company would operate HKIA at high standards.

AA's business case and valuation

Following the recent capital restructuring, Government's equity capital in AA stands at about HK\$ 30.7 billion. AA's return on equity is low especially in the context of a commercial enterprise.

In order for the market to ascribe a value to AA comparable to Government's equity investment, AA needs to demonstrate to potential investors that it will be able to achieve a commercial return within a reasonable timeframe.

As airport charges (currently comprising landing, parking and terminal charges levied on airlines in respect of their aeronautical activities) account for about 45% of AA's total revenues, an increase in airport charges will increase AA's return, alongside AA's strive to enhance productivity and efficiency.

This is a choice between trying to preserve taxpayers' investment by increasing airport charges in the next few years, or keeping airport charges more competitive at the risk of diminishing taxpayers' investment in AA.

There are arguments for and against increases in aeronautical charges which are summarized below:

For	Against
<ul style="list-style-type: none">• User pays principle• Airport charges account for less than 4% of airlines' operating costs• Airlines respond to demand, not levels of airport charges	<ul style="list-style-type: none">• Airport is a public infrastructure and a long term investment• Higher charges hurt the airport's competitiveness

We have not come to a decision and 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 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

Following the initial setting of airport charges mentioned above, it is important that a more transparent and objective mechanism is established for future adjustment in airport charges. An economic regulatory mechanism should provide a predictable and equitable charging regime that caters to the long term needs of the HKIA. In designing the framework, it is important to ensure that sufficient flexibility and incentive be retained to enable the new Company to maintain high quality services and operate successfully as a listed company.

Our current proposals on the regulatory framework have the following features:

- (xiii) Subscribes to the user pays principle; allows the new Company a reasonable return on its investment; and provides incentives for enhancing efficiency and increasing capacity to cater for demand.
- (xiv) Only airport charges (i.e. currently landing, parking and terminal building charges) paid by airlines are to be regulated.

- (xv) The target return for aeronautical activities is to be 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.
- (xvi) Future charges are to be set by way of consultation and negotiation between the new Company and airline's representatives every three years or as a need arises against a set of pre-agreed parameters.
- (xvii) In the event of disagreement, 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.
- (xviii) A set of service standards is to be established, on the basis of which a financial reward and penalty system would be devised to link the actual service standards to the level of airport charges.

Land use, competition and scope of business

AA has 49 hectares of earmarked land on the airport island that is available for airport-related uses. In addition, currently AA is limited in the scope of business that it may undertake outside the airport island and can only carry out such activities that are in keeping with the objective of promoting and maintaining Hong Kong's status as a centre of international aviation.

Concerns have been expressed by some stakeholders that AA would be privileged over other developers or other private enterprises given the land it holds and its status as the operator of HKIA, which may give rise to unfair competition or anti-competitive practices.

It is therefore necessary to balance the need to provide the new Company with maximum

expansion flexibility with the need for adequate controls in order to protect the strategic importance of this facility.

Accordingly the following proposals are being put forward:

- (xix) To allow the new Company to continue to hold and make use of the land on the airport island while maintaining existing controls over land uses.
- (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 is for consideration whether the requirement for AA to obtain Financial Secretary's prior approval for significant investments outside the airport 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) 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

Concerns have been expressed with regard to the welfare of workers and interest of companies operating at the airport post-privatization, particularly the possibility of job reduction or worker exploitation.

While these concerns are understandable, privatization per se should not cause any such adverse impact for the following reasons:

- AA is already operating under prudent commercial principles.
- In outsourcing, bidders are selected by AA on experience and service quality instead of pricing alone.
- A harmonious relationship with AA's business partners and employees at the airport is critical to maintain a smooth and efficient operation.
- AA has a lean structure and has no intention to lay off staff now or as a result of privatization; it will continue to be subject to employment related legislation.

Responses

You are invited to submit your comments on points (i) to (xxi) above or any other aspects of the proposed privatization in writing by 28 February 2005* to:

Economic Development and Labour Bureau
2/F Main Wing
Central Government Offices
Lower Albert Road
Hong Kong

Fax: 28684679
Email: airportcomments@edlb.gov.hk

All responses will be treated as public information unless otherwise specified.

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

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