



"C K Law"

12/04/2005 00:15

To: <airportcomments@edlb.gov.hk>  
cc:  
Subject: Wilson Fung--Submission form Cheung-kwok Law  
 Urgent  Return Receipt

Dear Wilson,

I attach my submission on the Consultation Document on AA's Privatization for your kind consideration. A hard copy, together with other attachments, has been sent by mail separately.

Best regards,

Cheung-kwok Law  PPAA2.doc

**Comments on  
“Consultation Document on  
Partial Privatization of the Airport Authority”**

by Dr. Cheung-kwok Law\*  
(11/4/2005)

The Chek Lap Kok Airport is the most valuable infrastructure project ever built in Hong Kong. According to an estimate undertaken by myself, the contribution of the aviation industry and other derived services, of which the new airport is an integral part, to Hong Kong's GDP was about 9% in 2000. Any changes in its governance structure, decision-making process and operational features should be undertaken with extreme care and supported by detailed assessment. Though partial listing of the airport could achieve some of the objectives stated by the Government (e.g. gaining efficiency, generating revenue), it should be reminded that equity financing is always more expensive than debt financing, and public interests could be undermined after listing.

From investors' point of view, particularly international fund managers, they are looking for a stock's intrinsic investment value, i.e. the historical rate of return and future income stream. According to the official document, AA's profit in 2002/03 was equivalent to only a return on equity of less than 2%. Such a return will not be attractive to most investors. Therefore, it is not advisable to arrange AA to be listed in the short term. Given the fact that Disneyland will commence operation later this year, more cities in the Mainland will permit individual travel to Hong Kong in next few years, the next phase of implementation of China's accession to WTO will invite more foreign investments, and the Mainland will host the Olympic Game in 2008, Hong Kong's CLK Airport should be able to achieve a more profitable business profile by 2009 and thus by then it would be a much better timing for public listing. Furthermore, 2006 to 2008 are election years for Hong Kong. The political environment may pose additional risk for listing during the period. No doubt, the improving fiscal position has substantially reduced the Government's pressure to sell assets urgently as well.

-----

\* Dr. Cheung-kwok Law is an Associate Director of the Aviation Policy and Research Centre of the Chinese University of Hong Kong. This is my individual submission, and the views do not necessarily reflect that of the Centre.

Other than the fact that right timing will be vital for a successful listing, Article 128, 129 and 130 of the Basic Law should also have a bearing on the legal basis for AA's public listing. For example, it is explicitly stated in Article 130 that the HKSAR should be responsible for matters of routine business and technical management of airports. Would public listing of the airport violate this provision? The Government should be very careful in clearing every relevant legal issues prior listing.

Before providing my comments to the Consultation Document point-by-point, the following five issues are highlighted as a summary of prime importance:

- (a) Given the strategic importance of the Chek Lap Kok Airport, the SAR Government should retain the control of the Board of the new Company, so that public interests will be taken into full account on all commercial decisions.
- (b) It is not essential to preserve taxpayers' \$30.7b investment in AA in the privatization exercise, as the new airport has been generating other direct economic benefits and vast economic externalities.
- (c) A flexible, bilateral negotiation mechanism between the new Company and airlines, based on a "duel-till" approach, is preferable to a direct government decision or a rigid formula on setting airport charges. Cross subsidization should be kept to a minimal. However, the LegCo should be given a consultative role to represent public interest, in case a final arrangement on airport charges can not be concluded voluntarily.
- (d) It is very important to define explicitly in the new AA Ordinance that certain data and information should be made available to the Government for supervisory and regulatory purposes. Similarly, some data and information should also be made available to airlines for a fair and smooth negotiation process.
- (e) Achieving high safety and services standards should be one of the primary objectives after public listing. Measures should also be put in place to promote and enhance operational efficiency of the airport.

In the following, I provide comments to each of the questions stated in the Consultation Document.

- (i) I strongly support that the SAR Government should be given sufficient power for exercising various regulatory functions. In order to achieve this objective, it is very important for the Government to identify clearly in the new AA Ordinance the data and information requirement in details to be supplied by AA for supervision and regulatory purposes. Please see the last part of attached Article 1 for reference.
- (ii) As the Government will remain as a majority owner of the new Company in the foreseeable future, the Government can appoint all board members anyway, including certain ex-officials. Thus, it would be redundant to seek the power to appoint a minority number of additional members to represent public interests (even for the long term). I am not sure whether this implies that the Government is preparing to shed her responsibility to appoint “ordinary” members to the Board representing public interests, once AA is listed. This concern is not without proper reasons. Following the MTRC’s listing in 2000, all of its independent non-executive directors would be nominated by the “Nomination Committee”, rather than appointed by the Government directly. Thus, the Government would not have full control of MTRC after listing. The strategic and economic importance of AA for Hong Kong is much greater than that of MTRC. I suggest that the Government should retain total control on the appointment of all AA Board members. Please see the middle part of attached Article 4 for reference.
- (iii) Given the strategic, and even national security, importance of the Airport, I suggest that more than half of the members of the new Company’s Board should be Permanent Resident (not ordinarily resident) in Hong Kong, and the Chairman should be a Hong Kong Permanent Resident with Chinese Nationality (not a Permanent Resident with foreign nationality). I have not come across the international airport of any major city being controlled by a foreign national.
- (iv) It is correct to propose that any single shareholder (including associates) should be limited to not more than 10% of the total voting rights of all shareholders. However, we should be aware about the possibility that several independent state-owned enterprises of the Mainland (Singapore’s state-owned companies may be another example) may control more than 10% of voting

rights together. Their decisions could be affected by the Central Government, rather than voting independently for the best interest of their respective shareholders. Additional measures may be necessary to introduce to safeguard against this. Furthermore, the concept of strategic investor could be explored.

- (v) I support this in principle, but the subject “ordinarily resident” should be replaced by “permanent resident”.
- (vi) to (x) I support these proposals.
- (xi) I do not consider it is essential to preserve the exact value of taxpayers’ \$30.7b investment in AA in the privatization exercise, mainly due to three reasons:
  - (a) The investment in the new airport at Chek Lap Kok has given the Government the opportunity to vacate a very valuable piece of land at Kai Tak. The market value and development potential for that piece of land could easily be over billions. Therefore, we can consider that the “net” taxpayers’ investment in the Chek Lap Kok’s Airport, after deducting the potential revenue generated from the sale of Kai Tak’s land, should be considerably less than \$30.7b.
  - (b) The new airport at CLK has generated a substantial amount of economic externalities and social benefits, including the development of virtually a new town at Tung Chung, and enhancing the property value all along the MTR Airport route. Thus, it would not be fair to recoup all the investment of \$30.7b, through the user pays principle, only from the airlines, travellers, and other users of airport facilities. The Government, representing the interest of the entire community, should absorb at least part of the cost for generating these externalities.
  - (c) Some of the direct investment in the new airport could be considered as “sunk cost”, and their economic value is zero. Expert opinions from accountants and economists should be sought to deal with this issue.

If all these three elements are taken in account, the “net” taxpayers’ investment in the new Airport needed to be preserved would be much less than \$30.7b. In order to achieve a fair value, a detailed estimation of the “real” rate of return and consultation with all the stakeholders will be essential. Please see the last part of attached Article 3 for reference.

Subsequently, regarding the answer for the second part of questions in (xi), it may not be necessary for airport charges to be increased over a period of three to five years after all. The rate of return on aeronautical services should be reassessed based on the new estimate of “net” investment as deliberated in the previous analysis. A smaller net investment value should result in a higher rate of return for aeronautical services based on the current level of charges. Additionally, if we postpone the public

listing for several years, there is a distinct likelihood that the rate of return on aeronautical services will be even higher. Thus, no substantial upward revision of the landing charges will be necessary.

- (xii) Based on the previous analysis for question (xi), the answer to this question is affirmative.
- (xiii) In conjunction with the previous analysis for question (xi), the answer to this question is affirmative.
- (xiv) I support the “dual-till” approach (please see the attached Article 2 for more detailed exposition on different price regulatory mechanisms adopted by other international airports). This will provide more financial discipline (any hidden cross-subsidy, even though desirable, would become apparent) and incentives for further development. However, it is also essential to keep airport charges competitive, and the comments to question (xi) should be given careful consideration. Currently, the level of landing charges for the CLK Airport is ranked about the 15<sup>th</sup> among the world’s international airports. Any upward adjustment for the charges, even if deemed necessary, should not seriously jeopardize and change this relative position. This should be a clear and easy yardstick for policy reference.
- (xv) My answer to this question is affirmative. Nevertheless, the issue of risk premium should be examined carefully. On one hand, core airport activities are a perfect-monopoly in nature, thus having little risk and should not demand any risk premium. On the other hand, given the 911-Incident and SARS, international traveling could be reduced sharply overnight for a sustainable period of time. Airport’s and airlines’ revenues would be reduced substantially. It is important to see how such downside risk should be assessed and factored into the IPO exercise? These are not market risks. Should the Government (representing the wider interest of the entire community) assume some of such non-market risks directly, or should airport users bear all of them? In the US, after the 911-Incident, the Federal Government paid for a substantial amount of additional insurance and security cost imposed upon the US airline industry.
- (xvi) The Document proposed a bilateral negotiation mechanism between the new Company and airlines for airport charges, within a set of broad parameters set out in the Ordinance. I expect these broad parameters would include the setting and permission of a reasonable rate of return, defining a price-cap mechanism based on some kind of (CPI-X%) formula, and establishing high safety and services standards. I accept that this “flexible” arrangement is comparatively desirable than decisions dictated directly by the Government or

just followed the result derived strictly by a formula.

- (xvii) However, in case both parties cannot come to a final agreement, the Government suggested that herself or a Government appointed panel should be empowered to adjudicate on the reasonable level of airport charges. Under such circumstances, as many important issues will involve wider public interests, I suggest that the relevant LegCo Panel should be consulted on this initially. Both the new Company and airlines, and other interested parties as well, should be invited for public representation. This provision should create additional incentives for both parties to come up with a solution between themselves, and provide transparency to the public. Subsequently, the adjudication panel should take into account the LegCo Panel's comments to decide on the final price adjustment. The judgment should be made public as well.
- (xviii) to (xxi) I support all these proposed arrangements.

Attachments for reference

Four Chinese articles published in the Hong Kong Economic Journal in the last few months.