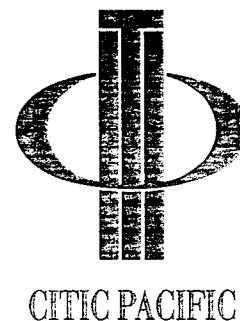


中信泰富有限公司

27 May 2005

Economic Development and Labour Bureau
Hong Kong SAR Government
2nd Floor, Main Wing
Central Government Offices
Lower Albert Road, Central
Hong Kong



Attn: Mr Howard Lee

Dear Mr. Lee:

Consultation on the Partial Privatization of the Airport Authority

CITIC Pacific has a significant interest¹ in Hong Kong aviation and thus is greatly concerned with the success of Hong Kong's airport and the development of Hong Kong as an aviation hub.

Opinion

CITIC Pacific believes that the proposed partial privatization of the Airport Authority will not be helpful to the development of Hong Kong aviation.

Reasons

The Consultation Document states the primary objective of privatization to be: "to strengthen the Airport Authority's market discipline in the running of the airport for greater efficiency and more commercial opportunities". We absolutely support an objective for the Airport Authority to become more efficient, but doubt that listing part of the share capital will contribute to this objective, for the following reasons:

1. A publicly held company has a strong pressure to make a high return, on a continuously rising trend. A privately held business can take a longer view of wider interests. The Consultation Paper is quite explicit in that it is intended that fees be raised to enable the IPO to be at a higher price. Once the Airport Authority is privatized, there will be further pressure to raise fees. This cannot assist the development of aviation in Hong Kong because it is contrary to what should be the primary objective of public policy – to keep Hong Kong and its airport as competitive as possible.

¹ In 1987 CITIC Hong Kong became the second largest shareholder in Cathay Pacific, and currently CITIC Pacific owns 26% of the airline. In 1990 CITIC Pacific reorganized Dragonair setting it on its successful path as Hong Kong's regional airline of choice, and CITIC Pacific owns 29% today. For many years CITIC Pacific has been a 10% owner of HACTL, and in 2003 bought a 25% interest in Air China Cargo.

2. Efficiency in an enterprise is not a function of being a listed or privately held. It is the result of a far-sighted, skillful and energetic management that can exist in any corporate structure. Consider:
- The Airport Authority's 2004 annual report describes an organization that already strives for efficiency and world-class practices. The Consultation Document describes the AA as a "very lean setup" (para. 33), and makes no proposal for changing its existing personnel or methods of operation that would result in improvement.
 - There are many examples of highly efficient, large privately held businesses, and it would not be difficult to find examples of inefficient and lethargic publicly held corporations.
 - Private equity managers have arguably been more successful than public companies over the last 20 years in increasing the value of businesses by long-term attention to efficiency. (See The Economist: The new kings of capitalism 25 Nov 2004)
3. The Consultation Paper focuses on the financial return generated directly by the Airport Authority at the airport from the capital invested in the Airport Authority. It does not consider the return to Hong Kong from money spent in hotels, restaurants and shops in Hong Kong by passengers who pass through the airport. The return to Hong Kong as a whole will be maximized by lower charges at the airport.

Appropriate view of the airport

In our view the airport should be considered a public facility that enables people to come to Hong Kong. It is analogous to the construction of roads that facilitate the conduct of business within Hong Kong. The objective should be to minimize the cost of providing a first class service to airlines and visitors so more of both are encouraged to come to Hong Kong.

There are examples of privatized airports in the world, and they are all in countries where there are numerous alternative means of accessing the country. In Hong Kong, the primary access point is the airport. An inexpensive and efficient airport is absolutely critical to the success of our city, and we believe that the overriding public policy should be to minimize the cost of using the airport, thus encouraging greater use.

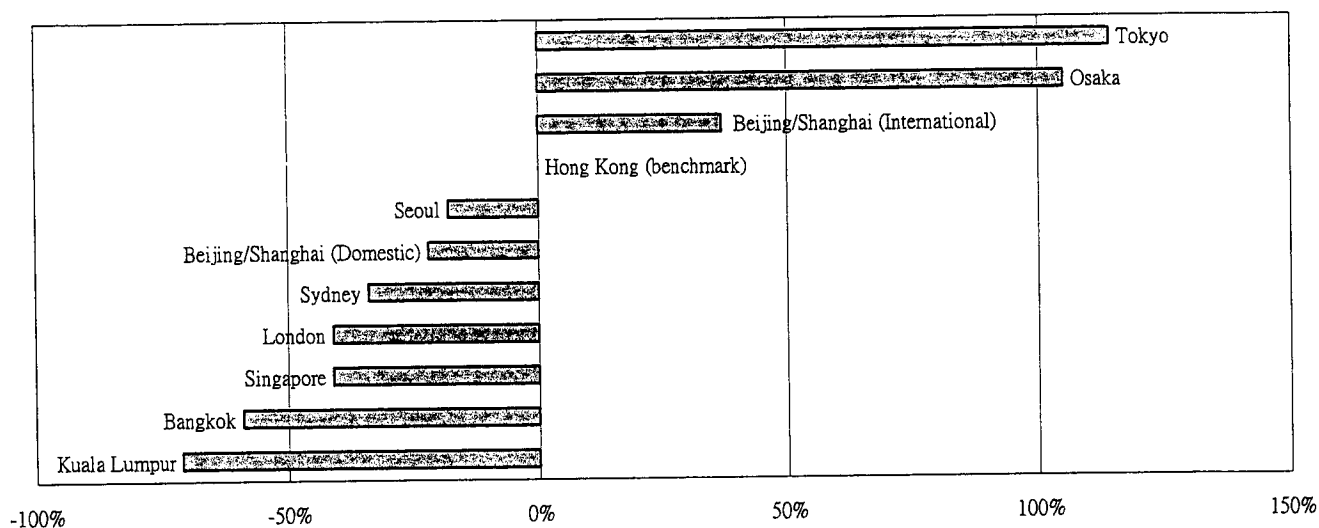
It should be noted that Hong Kong's airport faces many competitive threats from other airports in the region that covet our hub status, and the establishment of direct city-to-city routes.

How competitive is Hong Kong's airport?

The Consultation Document (Para. 15) says that current airport charges are comparable to the level in Singapore and lower than those in Seoul, Bangkok, Taipei and Mainland China. We understand that this could only be true from the perspective of the amount of revenue each airport authority receives from all charges it levies. Some of these charges will be made on

airlines, others are charged directly to travelers and others may be collected from passengers via the airline ticket. The practice at each airport differs.

An airline's perspective is different. It is concerned with the total cost it pays out by landing at an airport (i.e. it is not concerned with costs recovered by an airport authority directly from passengers, nor fees it put on a ticket acting as a collection agent for the airport). This chart – prepared from data supplied by Cathay Pacific – shows by what percentage Hong Kong's cost to an airline bears to other airports, using a typical B747 operation of 4 hours turnaround time:



Apart from Tokyo and Osaka, Hong Kong is clearly the most expensive airport in Asia. Beijing and Shanghai are odd cases in having a differential between charges for domestic carriers and foreign carriers which is contrary to international practice, and they will no doubt be unified in due course.

Does competitiveness matter?

The Consultation Document is right in saying that the level of airport charges of themselves is unlikely to be the driving force in an airline's decision to fly between a pair of cities. However, the cost structure of an airline must be looked at more broadly than just saying – as the Consultation Paper does – that airport charges in Hong Kong are 'only' 4% of total costs, so are not significant.

For example, the 2004 annual report of Cathay Pacific reports total costs of about HK\$34 billion. As the profit margin was only 11% in 2004, it is easy to calculate that if landing charges at CLK are 4% of total costs, they are equivalent to over 30% of the profits. Landing charges are one of many expenses that are very significant to the profitability of an airline. Aviation is a business where yields have been on a declining trend for over 20 years, making constantly reducing unit costs an imperative for success.

It should also be borne in mind that the world's airline industry as a whole is not profitable. Many airlines using CLK are loss making and will be very sensitive to the level of every expense.

The choice to be made

Paragraph 16 of the Consultation Document states "In the final analysis, the question is whether the costs of 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".

With the greatest respect to the author of the Consultation Document, there is no connection at all between recovering the costs of running the airport from its users, and an IPO.

Recovering costs

A glance at the 2004 Airport Authority annual report shows that in its current form, and with current charges, it was able to:

- generate cash from operating activities of HK\$2.1 billion,
- invest HK\$4.1 billion in new fixed assets,
- achieve a profit of HK\$386 million,
- pay a dividend of HK\$380 million.

These are major achievements² in a capital-intensive infrastructure project so soon after it began operation, and in a year when passenger numbers fell 6.5 million due to SARS. These results indicate the AA's charges are high and/or great success in retail sales to passengers. There can be no doubt that with the current charges and structure, the costs of running the airport will be recovered from users by the AA without an IPO.

"Taxpayers' investment in AA"

The concept of taxpayers having an investment in the AA is difficult to understand when so few people pay tax in Hong Kong. It might be more appropriate to say that the Government holds the AA as a trustee for all the people of Hong Kong. Is an IPO at this time in the interest of the people of Hong Kong? An IPO of part of the AA will reduce the value of the AA to the people of Hong Kong in two respects:

- a. a discount will be required by the investors to buy the shares;
- b. the value of the AA's future growth for the part sold will be transferred to shareholders throughout the world.

² All the more remarkable because the profit from developing the airport at Kai Tak has not been reinvested in CLK as would have been the case if the Hong Kong airport had always been operated on commercial principles.

If the Government's objective is to transfer to the people of Hong Kong the value of their investment in the AA, privatization might be better achieved if all the shares of a newly established private company were given to all citizens who could then choose to sell shares on the Stock Exchange or to retain them to participate in the AA's growth. Value would thus be transferred in full to the people of Hong Kong.

The questions that should be asked today are:

1. Will a sale today, when the AA is immature, maximize value to the people of Hong Kong?
2. Does AA require capital in the near future that cannot be acquired by loans³ or cash flow that indicates that it is necessary to sell prematurely to raise capital?
3. Would greater value be created if an IPO occurred when the AA is more profitable in the years ahead?

We believe the answer to questions 1 and 2 is negative, and question 3 positive.

If the airport is privatized

If the AA becomes partly listed, a regulator is definitely required to set limits to the AA's return. The regulation should cover the whole operation of the AA and be focused on an achievable return-on-capital for the whole business. There is no justification at all for regulating only airport charges for the following reasons:

1. The commercial revenue would not exist at all but for the traveler. The airport operations and the commercial activities are interdependent, and their results should be assessed together.
2. Modern business management does not attempt to make every product profitable in every transaction; it focuses on the return from each customer from all his relationship with the business. The AA's objective should be to derive return from each traveler/customer, i.e. the sum of charges to the airlines and profit on commercial activities taken together.
3. It should be a basic principle of the AA's operation that commercial revenue is a tool that will enable the AA to meet the overriding public policy objective to preserve and enhance the competitive advantage of Hong Kong through the lowest possible cost to the airlines landing in Hong Kong.
4. Dividing the AA's capital employed in the aviation-oriented activity and the commercial activity would be artificial and arbitrary.

The need for all the controls and restrictions on the AA described in the Consultation Document illustrates how limited is the privatization proposed.

³ With government ownership, and thus sovereign credit rating, the cost of the AA's debt would be very low.

The BAA is often quoted as an example of successful airport privatization. It is worth noting that one of the reasons London airport has a low cost to the airlines is that aviation and commercial costs and revenues are put in one pool; that there are no Government shareholders and no directors who are put in the ambiguous position of being "public interest directors".

If the AA is partially privatized, there should be a plan for the Government to divest all its shares over time so the AA can operate in an entirely commercial way. The public interest should be reflected in the operating requirement specified by the regulator, who should be a high quality, independent person supported by a team of experts. It is not satisfactory that the Government itself acts as regulator as proposed in paragraph 8.

Specific answers

Our answers to the specific questions are:

- (xi) It is not essential to "preserve taxpayers' HK\$30.7 billion investment in AA". HK\$30.7 billion is an artificial figure produced as a result of a HK\$6 billion dividend paid to the Government – it could be reduced further by the AA borrowing more and paying a bigger dividend to the Government.

It is not sensible to increase airport charges merely to achieve a bookkeeping recovery of money already spent. Airport charges should be market driven to make Hong Kong more attractive than other airports to maximize the return to Hong Kong in total (i.e. the AA, airlines, employment, taxes paid, tourist receipts, etc.)

- (xii) We attach more importance to minimizing any increase in airport charges in the next few years as the benefits of doing so to Hong Kong as a whole will far outweigh any increase in the valuation of the number of shares likely to be sold in an IPO.

Yours sincerely,



Vernon F. Moore
Executive Director

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|-----|------------|---|
| cc: | Stephen Ip | Secretary Economic Development & Labour |
| | Sandra Lee | Permanent Secretary EDLB |
| | Norman Lo | Director General Civil Aviation |

To: Economic Development and Labour Bureau

Fax: 2868 4679

Date: 28 May, 2005


Re: Privatization of the Hong Kong International Airport

Dear Sirs:

I am a Hong Kong permanent resident and a taxpayer. I am glad that the Government has decided to privatize the Hong Kong International Airport. I have read the consultation paper on the subject issued by you in November 2004. I think the privatization should proceed without delay. In particular, I agree with the following benefits of the airport privatization mentioned in your consultation paper:

1. The Hong Kong International Airport is the pride of Hong Kong. Privatization will ensure that it will continue to be run with efficiency and efficacy.
2. Privatization will allow small investors like myself an opportunity to invest in a safe and growth stock, which is also the pride of Hong Kong.

As a citizen of Hong Kong, I will be very disappointed if our Government succumbs to the pressure of the politicians and the big corporations and withdraw the plan to privatize our airport, as reported in the newspapers recently. I am sure that I am not alone and my view is representative of the average citizens in Hong Kong.



Yan Chong Pou