



30th May, 2005

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

Attention: Mr Stephen Ip

Dear Stephen,

I am pleased to present the views of Cathay Pacific Airways Limited on the subject of the proposed partial privatisation of the Airport Authority.

I look forward to your response in due course, and am available at any time to discuss the issue or to elaborate upon any of the matters discussed in the attached document.

With best regards,

Yours sincerely,

A handwritten signature in cursive script that reads "Tony".

A N Tyler
Chief Operating Officer

ANT/ec

cc: Mr Howard Lee - EDLB
Ms Sandra Lee - EDLB
Mr Peter Bysouth - IATA
Mr Howard Eng - AAHK

**Comments from
CATHAY PACIFIC AIRWAYS
on the
Consultation Document on Partial Privatization
of the Airport Authority
published by EDLB on November 15, 2004**

Hong Kong, 30 May, 2005

1. Cathay Pacific welcomes the process initiated by the Administration to seek the views of the public on the proposed partial privatization of the Airport Authority (AA). The following comments are set out in response to this initiative.

2. Cathay Pacific has participated actively in the discussions between IATA, BAR and the AA on the subject of economic regulation of a partially privatized AA, and supports the joint submission made by those entities. However we draw attention to the fact that these discussions, and the joint submission, were focussed on a form of economic regulation to which Cathay Pacific, along with all other airlines, is fundamentally opposed.

3. Cathay Pacific also supports and endorses the separate submissions made by IATA in January 2004 and May 2005, and BAR in May 2005.

4. In going forward with any plan to privatize the AA, it is essential that the major aim of developing and maintaining Hong Kong International Airport (HKIA) as an international aviation centre be upheld. The process has to provide genuine benefits to the people of Hong Kong at large. Any change for the sake of satisfying a short-term goal which is only beneficial to the privatized entity, and which risks undermining the competitiveness of Hong Kong, must not be pursued.

5. We offer our comments on the various questions and topics raised in the Consultation Document in the order in which they are presented in that Document. Because many of the topics are inter-related, this necessarily results in some repetition of themes and arguments.

Objectives of the Proposed Partial Privatization

6. We remain unsure of the real objectives for the proposed partial privatization. The results which the Government hopes to achieve from partial privatization as stated in paragraph 2 of the Consultation Document are not overwhelmingly convincing reasons to privatize AA. AA justifiably portrays itself as a very well run and efficient organization, with the evidence being the various internationally recognized accolades and awards that it has won. While any organization should always strive for further excellence, this objective could also be achieved through other approaches than privatization. The plan to privatize was prompted by the need to balance the SAR's budget deficit several years ago. However, with the rapid rebound of the Hong Kong economy, and a much better forecast outlook, this justification has been greatly diluted.

7. The Consultation Document offers no explanation as to how market discipline will produce greater efficiency or the exploitation of more commercial opportunities. The stock market will not discipline AA for operating inefficiently if AA is able to pass on its costs direct to its airline customers, as is being proposed. As to Hong Kong people being able to own shares in Hong Kong's airport, partial privatization will in fact enable, for the first time, some foreign ownership of the AA, which is currently vested entirely in Hong Kong through our Government.

8. There are two main reasons why other airports around the world have been privatized over the last twenty years or so, and neither of them applies to Hong Kong. The first is relevant to cases of mature, well-

developed and heavily utilized airports, and is the desire of government owners to raise cash for general purposes from the sale of a mature asset. The second common reason for privatization is the desire to raise capital for investment in the airport itself. HKIA is not a mature, heavily utilized airport ripe for a sale, nor has any argument being proposed that its privatization is primarily to raise capital for its own needs. Indeed, with its full Government ownership, it is able to issue cheap debt; as a private entity it may even find its debt costs will rise, and equity is in any event more expensive than debt.

Relationship between the Government and a Partially Privatized AA

9. We largely agree with all the principles and proposals set out in paragraphs 9 (i) to 9 (x) of the Consultation Document. With regard to the issue of Board membership and the Government's right to appoint a number of additional members to the Board to represent the public interest, we believe it is important that the Board should also contain an appropriate level of airline management expertise and experience. We suggest that representation from the airline industry through a recognized representative to the Board from this business sector be seriously considered.
10. In reviewing paragraphs 9 (viii) and (ix) we would also note that these powers of Government would act to reduce the financial risk to shareholders of the partially privatized AA. This should be taken into account in the determination of an appropriate rate of return for any regulated scope of activities.
11. Partial privatization will fundamentally change the relationship between the Government and the AA. At present, the Government acts as sole shareholder, but also represents the broader Hong Kong interest in the

development and operations of Hong Kong's most important strategic economic assets. Thus the Government is in a position to weigh the benefits of generating profits at the Airport against the disadvantages of increasing charges and costs to its users and partners of all kinds – especially, but not exclusively, airlines. Thus, during the SARS crisis, for example, Government prevailed upon AA to provide some financial relief to the airlines; although this was against the limited interests of the AA itself, Government deemed that it was in the interests of Hong Kong as a whole.

12. Once partial privatization has occurred, Government will no longer be in this position, since it would be unconscionable for it to use its position as a majority shareholder to force AA to act against all shareholders' interests. It will therefore no longer be in a position to act in the broader interests of the Hong Kong community. While paragraph 9(viii) does contemplate such a necessity, a decision to exercise any power of direction will be very time-consuming, contentious and controversial. In practice therefore the Government may not be in a position to perform the very important function of balancing the narrow interests of the AA's shareholders with the greater interests of the community of Hong Kong.

AA's Business Case and Valuation

13. While it is stated in paragraph 17 that a decision on the issue has not been made, the descriptions in the preceding paragraphs seem to suggest that an increase in airport charges is being seriously considered. This is confirmed by public and private statements made

in recent months by certain members of senior management of AA and AA's own financial advisers.

14. We believe that for a massive infrastructure project like that of Hong Kong International Airport, a long-term view of the realization of the rate of return must be taken. In addition, the rate of return must reflect the low risk nature of the investment, and the strategic role of the airport towards the bigger goal of contributing to the healthy and sustainable economic growth of Hong Kong.

15. We are concerned about the statement that a return on equity of less than 2 percent is considered far lower than would be considered reasonable from a commercial perspective. HKIA is at a very early stage of its project life. Like many other major infrastructure projects with very high depreciation costs in the initial years of operation, achieving a positive return on equity is already a highly creditable performance. The current infrastructure at HKIA could support traffic volumes far greater than its present activities. There will be very strong growth in traffic at HKIA in future years: the airport is situated at the heart of the world's fastest air traffic region, a city in China, the fastest-growing large economy in the world. This growth in traffic will certainly enhance the return of the AA. AA's return for the financial year ended in March 2005 must surely be significantly higher than that of FY2002-03, given the recovery in the general economy and the greatly increased passenger and cargo numbers. Furthermore, it is highly misleading to characterize the return by means of a snapshot of one year only. The average return generated over the entire life of such a project should be considered.

16. The Government has placed in the books of AA a sum of some HKD10.8 billion being the remaining unamortized value of the cost of reclaiming the land at HKIA. Under the regulatory regime being proposed by AA, the airlines will be responsible for generating a return on the part of this sum allocated to the regulated "till", and also pay the amortization costs of this allocated amount. We suggest that this represents an unjustified burden on the airlines, for the following reasons.
17. First, there is no reason why the costs should be amortized: the land will still be present and economically valuable at the end of the depreciation period. Secondly, the value of the land at Kai Tak (which must have been paid for many times over by the airlines' airport charges at that location) has not been offset against the cost of the new airport: this means that Government as the AA's shareholder will be receiving a double benefit at the airlines' expense. Nor has any account been taken of the much-increased value of land rights in Kowloon resulting from the lifting of height restrictions there. Government is taking unjustified and duplicated returns from the captive airline businesses.
18. In addition, considering the strategic role of an airport to the overall economic well being of the community, the level of return currently achieved by AA cannot be considered low. The strategic value of an airport goes much further than providing a financial return to the AA on a commercial basis. It is one of the most important drivers of the economic growth of Hong Kong. In addition, HKIA has generated further economic value. For instance, the presence of HKIA has created demand for residential and commercial activities in the nearby towns, thereby enhancing the value of the land in those areas, and bringing significant economic and financial benefit to the Government and people of Hong Kong.

19. We are also concerned about the other statements in the Consultation Document that:

- “AA would also need to consider increasing such charges if it were to achieve a reasonable return in the next few years” (paragraph 12);
- “there is no strong evidence to suggest that the level of airport charges will sway airlines’ choice of destinations” (paragraph 15);
- “AA therefore holds the view that some increases in airport charges will have little impact on HKIA’s competitiveness” (paragraph 15);

20. As expressed in our former comments, AA’s return should greatly improve with the business growth anticipated for this year and the forecast for the years ahead. Allowing an increase in airport charges for the sake of improving the valuation of the AA is in itself an inappropriate action. HKIA is still in its infancy in the life of the entire project and there is still a long way to fully utilize its current capacity. If its business maturity has not reached the stage to support an IPO, then the plan should be withheld until the airport business is more mature. Inflating its revenue by the forceful exploitation of a monopolistic position in order to entice investors is treating the priorities in the wrong order. It would be a mistake to pursue the short-term goal of putting potential investors’ interests ahead of the long-term growth prospects of Hong Kong and the economic interests of the people of Hong Kong.

21. For these reasons we would answer the questions posed in paragraph 17(xi) and (xii) as follows. We do not consider it necessary to achieve a valuation of the total equity in the airport at listing of HKD30.7 billion, and we would not consider it reasonable or acceptable to increase airport charges over any period to achieve such a goal. We see no need to increase airport charges at all in the next few years, if ever, because the taxpayers' investment in AA will be more than repaid by the returns generated from future traffic growth. Indeed it could be said to have been already paid for several times over by the value realized and realizable at Kai Tak and Greater Kowloon.
22. The two questions posed in paragraphs 17 (xi) and 17 (xii) stop short of asking the public what they might think if the increase in airport charges could result in higher airfares. We believe the general travelling public would be concerned to discover that their total travelling costs were being increased without justification. They would surely place more importance on maintaining the competitiveness of HKIA for the social and economic benefits that HKIA will bring to the economy of Hong Kong. We also believe that the public would consider their travelling comfort and the efficiency of the superb HKIA infrastructure to be non-economic returns of significant value.
23. Paragraph 15 of the Consultation Document reflects a misunderstanding on the part of AA of the effect upon the development of air traffic hubs of high airport charges to airlines. The fact that such charges may constitute a fairly small part of an airline's total cost is beside the point: airline route development decisions are based on **marginal** costs and revenues.

24. Consider, for example, the decision of Cathay Pacific whether to operate an additional flight to Manila. If forecast marginal revenue at current demand levels is greater than the marginal cost (of which airport charges would be some 15%) the flight will go ahead. If forecast revenue falls short of marginal cost, the airline will wait until demand has grown sufficiently. In the meantime, traffic which might have been carried on that flight will find another way to its destination – the opportunity for HKIA to serve transfer traffic to North America, Europe, China or Japan, will be lost to another hub.

25. Similar considerations apply to the case of an airline from outside Hong Kong. For example, an airline from Manila will deploy its aircraft to another airport if the prospects for profitability are superior, and traffic for Europe or the Middle East, say, will transfer at that other airport. The cumulative effect of many such decisions by airlines will have a major impact on the future development of HKIA as a transfer hub if its charges to airlines are too high, notwithstanding that such charges may constitute only a small proportion of airlines' total costs.

26. We therefore do not agree that the level of charges will not sway the airlines' choice of destinations. In the short term, some travel may be locked in. Over time, however, the choice of a transfer point, the locations of conferences, regional sales offices, logistics centres and so on will be influenced strongly by the cost of air travel and transport. The view that airport charges can be set high with no consequences is simply incorrect. High cost markets will not enjoy service expansions by foreign carriers, and will stifle the economics of expansion of the hub carriers, both of which will be damaging to the economic growth of Hong Kong. It has to be remembered that on top of landing and parking fees, airlines also pay land rent, rent for space in terminals for offices, stores and lounges, and also various other airport charges such as

franchise fees levied on service suppliers, which are directly passed on to the airlines.

27. The view that HKIA is still competitive in the region and thus there is room for higher charges is alarming. A recent study by the International Air Transport Association submitted to the Legislative Council Economic Services Panel on 29th April 2005 compared the charges for airports in Bangkok, Hong Kong, Kuala Lumpur, Seoul, Singapore, and Taipei. The study indicated that "Hong Kong International Airport is still the most expensive airport in the region for Landing Charges, for Charges paid by the airlines, for Charges paid by the passengers and consequently the Total Charges per Flight. It is more expensive whether it be for the medium weight short to immediate range A320 and for the heavy weight long range B747-400". On this basis, any further increase in charges would only serve to weaken the competitive position of HKIA vis a vis these regional international airports.

Economic Regulation

28. We are concerned to read the inherent assumption apparently underlying paragraphs 18 and 21 of the Consultation Document that airport charges can or should be increased to improve the new company's return. We reiterate our view that it is the wrong priority to allow airport charges to be increased for the sake of achieving the IPO.
29. We agree with the need for a well-defined regulatory framework for airport charges to be developed and agreed before the implementation

of the IPO. Apart from the proposed regulation of airport charges paid by airlines (i.e. currently landing, parking and terminal building charges), other pertinent charges such as charges for fuelling facilities, certain security charges, the levy on ground handling franchisees and rental charges for airlines and ground handling franchisees should also be subject to some regulatory mechanism. While some of these other charges may not be charged directly to the airlines, they are usually simply passed on to the airlines by the respective service providers.

30. The proposal to have completely separate tills or a narrow "aeronautical" till in the AA's accounts when determining airport charges is not an acceptable arrangement. It is surely self-evident that there is a very strong symbiotic relationship between airlines and airports, as each needs the services provided by the other. Economic activities at airports are generated by the presence of airlines. The ICAO policies on airport charges suggest the adoption of a single till or at least a widely defined "aeronautical" till.
31. It is stated in the Consultation Document that the proposed narrow till arrangement is a better alternative because excluding commercial revenues from the regulatory framework would offer more incentive for the new Company. It is also stated that making the aeronautical operations a commercially viable business on its own would better encourage the new Company to maintain its aeronautical services at high standards (paragraph 22 (xiv)).
32. We do not agree with these statements and there are no convincing arguments put forward in favour of such a regulatory arrangement. In our view, the basis for such a proposed arrangement is weak. Under the current regime of wide till practiced in the UK, for example, there has been no evidence of a decline in the incentive for BAA plc to

pursue commercial opportunities at the three London airports. Retail floor space has increased by 80% over the last seven years – a growth far in excess of passenger numbers. The same holds true for HKIA, with the opening of Sky Mart in March 2004 adding significant retail floor space to HKIA.

33. We are concerned that a proposed narrow till approach would cause aeronautical charges to rise significantly, notwithstanding the suggestion in the Consultation Document of a lower target rate of return for the regulated activities. This would delay and retard the development of the hub at HKIA.

34. A narrow till system would require that assets and costs associated with the relevant activity be allocated. In practice, much of this allocation can be done only in some arbitrary fashion, and this will result in constant arguments between the relevant parties.

35. The single or wide till system is designed to share airport costs and revenues. This is surely appropriate where the sources of revenue are highly related and complementary, for instance, retail revenues from passengers who shop in the passenger terminals. Where revenues and costs of other discrete investments are concerned, e.g. the planned Exhibition Centre or investments in airports outside Hong Kong, they should not be included. This is not to suggest that double standards be applied. Activities of passengers and other users in the passenger terminal are indivisible from activities of the airlines that also use the terminal to serve their passengers. Other investments are totally different from the shops and passenger-related facilities in the airport terminal itself and bear no relation to the airport's operation.

36. An extremely comprehensive economic regulation study was conducted by the UK Competition Commission in 2002, in which the interests of the airports, airlines, passengers and the economy as a whole were taken into account. The conclusion was that the single till, despite its apparent shortcomings, was superior to any other regulatory model and was therefore to be retained for the BAA airports. In fact few airports around the world practice the proposed narrow till arrangement.
37. In the event of disagreement between the AA and the airlines, we are of the view that the appointment of an independent panel, while not totally without merit, would be time consuming and costly to both sides. It would not provide an efficient method to resolve disputes on charges and other matters. There would be a strong reluctance on the part of the airlines to get involved in such a process given its cost and the damaging effect the attendant publicity could have on the airlines and their relationship with the AA. Far better, in our view, to prevent such disputes from arising in the first place by an effective consultation and regulatory process. We see an important continuing role for the Government in this context.

Land Use, Competition and Scope of Business

38. We do not have particular comments on the points set out in paragraphs 23 to 27 of the Consultation Document. By and large, the proposals stated in paragraph 28 are sensible approaches.

Impact on Companies and Workers at the Airport

39. We do not have particular comments on the views expressed in paragraphs 29 to 33 of the Consultation Document.

Conclusion

40. There is no doubt that HKIA has an extremely important and strategic role to play in the development of Hong Kong's economy and prosperity. The Government appears to recognize this in its comments in the Consultation Document on the proposed relationship between the Government and the new Company, and the proposed regulatory controls.
41. However, the recognition of HKIA's strategic role for Hong Kong does not seem to be apparent when it comes to the business case and valuation of AA. In this part of the Consultation Document, there is too much emphasis on the need to achieve a valuation that will be supported by potential investors at the level of preserving the taxpayers' investment in AA. And the proposed way to achieve this seems to be through increases in charges to airlines: this gives us grave cause for concern.
42. In summary we reiterate our views as follows:
- We believe that the reasons stated for the proposed partial privatization are not convincing.

- We do not agree with any plan to increase airport charges simply to achieve any pre-determined valuation at the IPO. The IPO process should not be a reason or an opportunity to raise charges.
- We believe that any increase in airlines' airport charges would be highly undesirable and damaging to the development of HKIA as a preferred aviation hub. Such an increase would only serve to dampen aviation growth and thereby hinder the economic development of Hong Kong.
- We do not agree that the current level of airport charges paid by the airlines is comparable to Singapore and lower than those in Seoul, Bangkok, and Taipei.
- We do not agree that the level of airport charges will not sway airlines' choice of destinations.
- We support the introduction of an improved regulatory mechanism for airport charges; one which takes account of the contribution made by airlines to profits from retail and certain other aviation-related sources.
- We believe that the best strategy going forward for HKIA is to further enhance its competitiveness by increasing its efforts to improve productivity, and to charge airlines at levels which encourage the development of air services at HKIA.
- If it is believed that the current financial performance of AA is not sufficiently strong to support a successful IPO without increasing airport charges, then we think it would be sensible to postpone the

privatization plan until AA's business is more mature, with higher traffic volumes and revenues.
