



Andrew Work

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Please respond to
andrewwork

To: airportcomments@edlb.gov.hk
Simon Lee
Andrew Pak Man Shuen
cc: airportcomments@edlb.gov.hk
Subject: Lion Rock Institute Submission on Airport Authority Privatization
 Urgent Return Receipt

Dear Sir/Madam,

Attached you will find the submission on Airport Authority privatization from The Lion Rock Institute. Please confirm receipt. Thank you for your attention.

Sincerely,

Andrew Work

"How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it, except the pleasure of seeing it." Adam Smith, *The Theory of Moral Sentiments, Part I Section I Chapter I*

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LRI on Privatisation of the AA.pdf



May 31, 2005

**A Submission on the Privatization of
the Hong Kong Airport Authority**

in Favor of

**A Completely Privatized
and Deregulated Airport Authority**

The government of Hong Kong has entered a plea for consultations on the issue of Airport Authority (AA) privatization. The Lion Rock Institute (LRI) is happy to answer that call with the following submission.

The LRI is broadly in favour of removing major assets from government hands and placing them in the market sector. This includes the AA and associated assets. The LRI contends that privatization exposes assets to the efficiency driving forces of the market, while government ownership presents the prospect of assets managed for political aims of those who can use the coercive power of government to serve their ends at the expense of others.

The Airport Authority presents an excellent opportunity to privatize a major government asset. It is by many measures one of the best in the world with a management team capable of managing the transition to a completely private sector asset. A complete privatization with accompanying deregulation of its activities will not only be good for the airport itself, but could also act as a fillip to the government's overall program for increasing the role of the private sector in public life.

Given more time and more resources, the Lion Rock Institute would welcome the opportunity to develop a more detailed framework beyond the scope of this brief submission.

The LRI contends that a privatization, properly designed and executed, can benefit the people of Hong Kong, minimize distortions in the economy and create a space for Hong Kong to maintain its world class standing in aviation and as a hub for the world.

Submitted by
The Lion Rock Institute

Written by: Andrew Shuen Pak Man
Research Director

Andrew Work
Executive Director

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Executive Summary of Proposals

We believe the proposed actions regarding the Initial Public Offering ("IPO") of the Airport Authority ("AA") would benefit the people of Hong Kong with the following adjustments in the proposal:

- a) The government should set the complete privatization of the AA as the ultimate goal of aviation policy. This means a complete transfer of equity to the private sector and deregulation of operating strictures placed on the AA.
- b) The free market, along with the pressures and disciplines it generates, provides the best measure of creating efficiency and services tailored to serve the many customers of the airport and the people of Hong Kong.
- c) The imposition of temporary performance targets ("Targets") on passenger and cargo traffic flow through the Hong Kong International Airport that is pegged to prior increases in traffic flow with regards to general macro economic performance in the time period immediately after the IPO.
- d) The imposition of a strict time schedule on the sale of the remaining stake of the AA by the government to the public if the Targets are achieved.
- e) The government should remove a range of proposed strictures, instead reserving "the nuclear option". The "nuclear option", outlined in item 9.(ix) of the government **Consultation Document on Partial Privatization of the Airport Authority** ("the Consultation") should also include examples, although not limits, of what constitutes an "emergency situation". Strictures to be removed include items 9. (i)-(v), 9. (vii-viii), 22.(xiii-xiv, xvi-xviii) and 28(xx-xxi)..

Complete Privatization of the Airport Authority

Purpose and Guiding Principles

We firmly believe the complete privatization of the AA should be established as part of the ultimate goal of the withdrawal of the government intervening and controlling the aviation industry in Hong Kong.

Moreover, we would like to stress that the sale of a partial and non-controlling stake in the AA to the private sector without the government ceding control over operations, does not constitute privatization. Hence, we express our hope that the government resists continuing to invoke the term "privatization" to describe the proposed actions as suggested in the Consultation Document to avoid public confusion. However, we do believe that the proposed IPO is an important and significant step towards our desired goal of complete privatization of the AA.

We believe that the transfer of ownership and operational control of the AA from the Government to the private sector would enhance the efficiency, operational performance and contribution of the AA to the Hong Kong economy. Furthermore, it would serve to safeguard the AA against political interference in the future by institutionalizing operating and owner independence.

We also believe that with the further integration and relaxation of travel in the immediate surrounding regions of the Southern Pearl River Delta area, that the current market the HKIA serves will become fully exposed to competition and alleviate concerns over the concentration of market powers in the hands of the AA. Hence the economic vitality sapping hand of government intervention will no longer be justified.

Privatization: Three Guiding Principles

The LRI advocates “Three Guiding Principles” to effect a successful privatization. They apply in the case of the AA.

A successful privatization requires:

1. **A complete privatization** in terms of ownership and deregulation. That is, 100% of ownership should be transferred to the private sector and operations should be free of government oversight.
2. The construction of **a robust legal framework**, clearly spelling out the terms of the privatization and clearing potential legal obstacles, should be a pre-requisite to acting on a planned privatization.
3. Be supported by **a comprehensive campaign to explain the benefits of privatization to the public** to gain support before proceeding.

It is recognized that reconciling all three may be difficult, especially in the case of 1 and 3. However, it should not be an excuse for not developing all three – without establishing them, a successful privatization is doubtful.

Complete Asset Transfer and Deregulation

Complete Asset Transfer and Freedom of Ownership

In response to items 9.(ii)-(v) of the government Consultation, we believe firmly that there should be no restriction on ownership of the AA. We contend that there are sufficient safeguards to public interest without the restriction of ownership similar to those of the Broadcasting Ordinance and Telecommunication Ordinance. In fact, although beyond the scope of this consultation paper, we believe that the ownership restrictions as prescribed by the Broadcasting Ordinance and Telecommunication Ordinance have retarded the development of those particular industries and led to an economic loss stemming from the reduction of innovation and creativity by the limitation of participation by non-resident in those industries.

While the government assumes those Hong Kong Residents who are not Chinese Citizens to be able to guarantee the strategic airport facility will continue to be managed by predominately Hong Kong residents, it does not guarantee the facility will be managed in the interest of Hong Kong. However, we believe that with our proposed changes to the AA's IPO, we align the interest of these directors and shareholders with the people of Hong Kong, and hence harness the energy spent by the relevant party's pursuit of profit to the benefit of all consumers who the HKIA currently serves.

Specifically, with regard to:

Item 9.(ii) *“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 publicly listed AA should have sufficient oversight and publication required of it as a publicly listed firm. The Government states an admirable aspiration to avoid “pre-empting the Board’s commercial decisions.” However, the Government and other stakeholders should be able to make their views known through the media, private consultations and other methods major firms use to communicate with their community.

Item 9. (iii) and (v) *“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.”* and *“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.”*

Restricting ownership and control to Hong Kong residents, as stated above, does not guarantee that the AA will be run with the best interests of Hong Kong in mind. It also reduces the attractiveness of the AA as an investment by limiting the number and control of potential investors.

Item 9.(iv) *“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.”*

Restricting ownership by non-government bodies to less than 10% defeats the purpose of privatization. It effectively leaves the government in control of the facility and its management vulnerable to political wrangling among various stakeholders who would use politics to further their own ends without concern for the shareholders and other stakeholders.

It also deters investment as investors have little to means to enact any control over the direction or management of their investment. It would almost be akin to buying government bonds, not shares in a company. Furthermore, it weakens the opportunity for oversight and discipline brought about by active shareholders with significant shareholdings.

Deregulation: Allow the AA the Freedom to Thrive

Deregulation needs to be enacted to allow the AA the room to make commercial decisions in a competitive environment.

Suggestions 9.(i)(ii)(vi)(vii) (viii) and (x) reveal a privatization that is not a privatization and should be dropped from government proposals. It makes the AA in effect a management team subcontracted by the government. It reserves the government the right to determine plans, control hiring and firing, impose penalties and revoke the right to manage. These are all normally the prerogative of an owner. It is under these conditions that the term “privatization” becomes a misnomer for this project.

Maintaining the nuclear option outlined in 9.(ix) would provide the necessary safeguard for the Hong Kong public and serve as a cautionary to foolish shareholders and/or the administration. Even that guarantee should be carefully circumscribed with a clear definition of “emergency situation”.

Airport Charges

We believe that the issue surrounding the possible change on airport charges to be completely independent from the proposed IPO of the AA. The main concern by incumbent airlines based in HKIA of increased airport charges could occur even without an IPO of AA.

In fact, we support any adjustment in airport charges by the AA in search of a higher return based upon the principle of profit maximization prior to, and after, the IPO of the AA. Once a government controlled AA were to embark upon profit maximization and AA were to subsequently revert to private sector control, we could see airport charges to airlines fall as experienced in London Heathrow Airport after the privatization of the British Airport Authority. Increased revenues in retailing from increased traffic more than compensated for lower landing fees.

We firmly believe that with the competition posed by the airports in the surrounding areas, namely Macau, Zhuhai and Shenzhen, that if the AA were to successfully impose charges higher than airports in major Asian metropolis with high volumes of international air traffic without affecting traffic in Hong Kong, that it is merely a reflection of the superior management by the AA of the HKIA and not a sign of abuse of supposed, but nonexistent, market power in pricing.

However, if the AA chooses to impose airport charges lower than the market clearing price prior to AA's IPO, we consider it reasonable and acceptable to increase airport charges over a period of three to five years for HKIA's charges to be inline with market clearing prices.

In fact, the suggestion by many that the AA could raise fees with little impact on traffic suggests that the low return on equity (cited as less than 2% in the Consultation) arises from the AA subsidizing other parts of the transportation equation. Raising fees to a market-clearing price would eliminate this taxpayer subsidy. Former actions by airlines do suggest they have market power in dealing with the airports¹ and margins that allow them to compete with low cost carriers². Suggestion 22.(xvii) on creating a multi-party panel to determine provides the platform for politicking for advantage outside of market disciplines and should be avoided.

It should be noted that market-clearing price can only be known when pricing is deregulated and the market disciplines the AA on pricing issues. This also suggests that proposal 22.(xiv) should also be scrapped in favour of no regulation of pricing. At London Heathrow, the connection between retailing and volume has allowed for a lowering of fees as profitability from shops rose.

Suggestions that regulations proscribe the scheduling of fee setting (22.(xiv)) would remove a current flexibility in responding to market conditions and put the AA at a disadvantage to competitors who could reschedule at will around market conditions to Hong Kong's detriment.

Furthermore, regulating the return on investment, regulating fees and providing "incentives for enhancing efficiency and increasing capacity to cater for demand" (22.(xiii)) effectively substitutes a set of government created guidelines to drive incentives in lieu of the market – again, negating the main benefit of privatization and leaving the AA hostage to myriad competing political considerations over commercial interests.

¹ HK cuts fees to entice airlines, CNN.com, May 27, 2003
<http://edition.cnn.com/2003/WORLD/europe/05/27/biz.trav.hk.airport/>
and Airport faces fee pressure, News Guangdong, August 3, 2004

² Asia budget airlines face challenges, The Hong Kong Standard, May 9 2005
<http://www.thestandard.com.hk/stdn/std/World/GE09Wd06.html>

Building a Robust Legal Framework for Effecting Privatization

The extensive detailed legal work needed to be done to effect a successful privatization is outside the scope of this brief submission.

Suffice it to say that the terms and scheduling of the privatization should be extensively and wholly vetted by better qualified legal minds to avoid the unfortunate complications suffered by the Link REIT

Basic Law Articles 128, 129 and 130.

We do not believe that the complete privatization of the AA nor what has been proposed by the government in the consultation paper to contravene the Basic Law.

Building Public Support

Public support is crucial for the success of a real privatization as suggested by the LRI. Many have concerns over the activity and success of a privatized AA arising from fear-mongering among private parties with a self-interest in keeping fee regulation in the hands of a government they feel better equipped to manipulate, whether or not that is the case.

Targets on Traffic Flow

We believe that a set of targets for improved traffic flow through HKIA based on a formula that would consider general macro economic performance to be an adequate proxy to the desired contribution the HKIA makes to the Hong Kong economy.

We therefore believe that if post-IPO traffic flows grows quicker than historical norms as compared to general macro economic performance that the scope of privatization of the AA be widened and the government's control be further reduced.

We propose these measures with the intention of working towards exact targets should this be accepted in principle.

The intent is to assure the public that the AA will continue to maintain its award winning standards and continue to serve Hong Kong well. As proponents of privatization, we would not recommend this as a public trust building measure unless we had full confidence in the current AA administration to thrive in a free market environment.

Make Clear the Benefits of Privatization

The government and other interested parties supporting (a complete) privatization of the type recommended here need to boldly present the benefits to the public in a coordinated campaign that could run concurrent with procedures to establish the legal framework and legislative structures.

The government should avoid equivocating or downplaying the impact of privatization on the people of Hong Kong. With the potential to be an excellent benchmark for future privatizations, it is essential that this effort is public, accepted, and successful to advance the larger privatization agenda.

Assuring the Public the Government Has the Ultimate Power “The Nuclear Option”

Given the rampant scare-mongering and suggestions that air travel to Hong Kong would halt under a private airport scheme, the government should reassure the public that it reserves the aforementioned “nuclear option” to assume control of the airport in the event of a complete cessation of service or dire emergency situation, such as war, plague or a terrorist event.

A Note on Return for Taxpayers

Although we support any changes in the airport charges prior and after any possible IPO of the AA, we firmly believe such changes should not be imposed for considerations of returns for taxpayers.

We do not believe that the merit of a true privatization, one conducted in pursuit of greater efficiency and economic contribution of the asset privatized, should ever be measured against the revenue raised by the privatization. In fact, we believe that the revenue raised from any privatization related IPO should be revenue neutral to the government and therefore be accompanied by a reduction in government taxation.

We appreciate that the pattern of taxation unrelated to the proposed IPO is beyond the scope of this privatization, we express our hope that the government adopts a goal of revenue neutrality when considering IPOs of government owned assets.

We also appreciate that currently, returns for taxpayers are considerations for some members of the public when judging the merits of a proposed privatization. A clear and transparent path to private sector control can be demonstrated to those very members of the public. We believe that the public will support the proposed IPO when the possibility of increased efficiency and economic contribution by the AA through complete privatization is understood.

Conclusion

The current recommendations contained in the government report recommend:

- Controlling airport charges through pricing scheduling of price changes and control of pricing control boards,
- Creating an incentive structure around government chosen targets,
- Creating multiple opportunities for government to determine policy from approving capital expenditure, determining permitted activities, approving plans, collect information and impose fines, and set standards,
- Determining who shareholders should be in addition to the government
- Restricting minority shareholders rights.

This makes it very unclear why such a privatization is being considered for reasons other than filling a hole in the government revenue – probably the worst reason to undertake a privatization.

Given more time and more resources, the Lion Rock Institute would welcome the opportunity to develop a more detailed framework beyond the scope of this brief submission.

A real privatization that freed equity and management control to the market would not harm Hong Kong and would result in continuing success for our airport and provide a great service to the Hong Kong people. The airport and its current management provide the best opportunity for a full-scale privatization as outlined in this report.

The government should welcome this opportunity and be careful in deliberate in crafting a successful privatization with wide-spread public support.