

31 May 2005

Ref. GH/LS05-036/tm

Mr Stephen Ip Shu Kwan, GBS, JP
Secretary
Economic Development and Labour Bureau
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Central Government Offices
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Central
Hong Kong

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Dear Mr Ip,

Reference: LC paper No. CB (1) 230/04-05 (3) Legislative Council Economic Services Panel; Privatisation of the Airport Authority, 22 November 2004

Please find enclosed the IATA submission in response to the Legislative Council Paper referenced above. The enclosed IATA paper lists differences to that jointly filed by IATA, BAR and AAHK in their joint submission dated 31 May 2005.

The attachment has an Executive Summary and a brief Paper. Also included is the IATA submissions that track the full extent of our response to the SAR Government's request for comment on the possible privatisation of the Airport Authority (AA). Summarised argument in the attachment is explained in detail in the enclosures.

Even with your extension of the closing time for Public and Industry Submissions to the 31st May 2005 and, in spite of the intensive work undertaken by the IATA, BAR and AAHK Working Group and Plenary Team, it has not been physically possible to complete the given task. That is design and recommend an economic regulatory system for a partially Privatised AA. There are still some outstanding issues of detail as well the IATA fundamental issues to be resolved. Never the less, the progress to date is significant and definitely a historic example of airline industry and airport co-operation within the region. It is also testimony to the professionalism of the approach undertaken by the teams in what have been intense and often robust discussions.

While the Plenary Team has not yet reached the bottom line and everything in the submission bears the broad caveat that "nothing is agreed until everything is agreed" there are still significant elements of the joint submission that could be used in the economic regulation of Hong Kong International Airport (HKIA) today.

The IATA reports are submitted for the SAR Government's most careful consideration.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Peter Bysouth', written over a horizontal line.

Peter Bysouth
Assistant Director
Airport and ATC Charges

Enclosures:

1. IATA Submission to Economic Development and Labour Bureau dated 31 May 2005 in Response to Legislative Council Paper No. CB (1) 230/04-05 (3)
2. IATA Submission to Economic Development and Labour Bureau dated 14 January 2004 on the Need for Economic Regulation of the Hong Kong International Airport
3. IATA Submission to the Economic Services Panel Legislative Council of Hong Kong dated 31 January 2005 on Privatisation of the Airport Authority of Hong Kong
4. IATA Submission to the Economic Services Panel Legislative Council of Hong Kong dated 29 April 2005 on Airport Charges Comparisons
5. IATA Director General's speech to the Aerospace Asia Forum Hong Kong dated 15 April 2005

IATA Response to the Hong Kong SAR Government Proposal for the Part Privatisation of the Airport Authority

“The Wrong Decision for the Wrong Reasons at the Wrong Time”

In Summary

The Hong Kong Special Administrative Region (SAR) Government's “*Consultation Document on the Partial Privatisation of the Airport Authority, November 2004*” requested input and comment on the proposed Initial Public Offer (IPO) of shares in the Airport Authority (AA) and on aspects of governance for the to be listed new company (New Co). It also sought comment on their desired model of economic regulation for the privatised monopoly. The Government separately requested the International Air Transport Association (IATA), the Hong Kong Board of Airline Representatives (BAR) and the AA to examine the proposal to form a joint industry plan for the regulation of the aeronautical elements of the New Co.

The *Consultation Document* followed earlier discussion with industry that began in December 2003. IATA responded to those discussions with a paper on “*The Need for Economic Regulation of the Hong Kong International Airport*” (Enclosure 1). Since that time IATA has willingly participated in an effort too not only support our Member airlines but also to focus on the best long-term solution for the aviation industry in the SAR. The focused aim of the IATA approach has been that what is best for growing, sustaining and qualitatively improving the aviation industry in Hong Kong is also good for all SAR stakeholders and consequently IATA's Member airlines. This was clearly set before the Economic Services Panel of the Legislative Council in January 2005 (Enclosure 2). All of the enclosed IATA releases and documents are a total part of our reasoning, justification and argument. These documents are to be read in conjunction with the regulatory proposal and the exceptions listed in the final IATA/BAR/AA Joint Submission dated 31 May 2005.

IATA supports any Governments right to decide the ownership of its airport(s) and air navigation organisation and facilities. However, as the airline industry representative and a partner to the Chicago Convention outcomes, we reserve the right to oppose decisions where we believe they may not be to stakeholders or the industry's benefit. It would appear beyond doubt that the Government's proposal to sell shares in the AA was prompted by the debilitating effects of the Asian Financial Crisis and subsequently by the SARS epidemic on the narrow tax base of the Hong Kong SAR. Those stressors are no longer present.

In April this year, when addressing Hong Kong academics, press and industry leaders, IATA Director General Giovanni Bisignani compared the selling of the AA to the selling of the Crown Jewels (Enclosure 3). He said it was a doubtful policy: “*Do not do it if you do not have to*”. Selling AA shares would be the wrong decision for the wrong reasons at the wrong time.

Wrong Decision

The Aviation Policy and Research Centre of the Chinese University of Hong Kong (APRC) has assessed that the airport contributes 10% of the SAR GDP and that:

“Regardless of the manner in which AAHK is privatised, the Government's control over its operations will be decreased.”¹

¹ APRC Submission to EDLB on the Partial Privatisation of the Airport Authority 27 May 2005-06-05

Willingly giving up control of 10% of any countries or regions GDP is most definitely a wrong decision. Although a colloquial saying, HKIA is literally 10% of the SAR's "Crown jewels".

Wrong Reasons

The Hong Kong SAR went through "testing times" during the Asian Financial crisis. The narrow property dependent taxation base meant serious problems for the Government and gave rise to the first talk of a Hong Kong International Airport (HKIA) privatisation in 1998. The SARS crisis that followed compounded the problem. That time has passed; the SAR economy is back on its feet and growing steadily. HKIA passenger numbers, which had dipped below 28 million per annum, are now growing at above pre-SARS rates and due to go through 40 million per annum at the end of this financial year. AAHK is already an efficient, competent and multi-award winning airport company. And, while not as competitive within the region as it could be with its relatively high landing charges and an even higher departure tax, there is no longer any pressing reason to privatise the "Crown Jewels" (Enclosure 4).

Wrong Time

Airports are generally sold when they are mature assets i.e. Sydney Airport after the Olympic Games, or by Governments requiring finances and/or to fund expansion or new investment. HKIA is a very young airport that will not require major new investment until passenger numbers go through 55 million. At that time the returns will be more than sufficient to fund the new Mid-Field Terminal with only a small, if any, increase in aeronautical charges. Now is not the time to sell the "Crown Jewels". Now is the time to consolidate the business and to regulate for further efficiency.

Regulation

Although IATA does not support Privatisation at this time, we do recommend subject to final endorsement by IATA, BAR and AAHK, that the Government consider the economic regulatory system that is being developed by the parties. The economic regulatory system has been designed to lead the parties to consensus decisions, to avoid regulatory gaming and unnecessary expense while focussing on the best outcome for all stakeholders. However, IATA and BAR have two significant caveats (the exceptions). The first is in reference to the Governments insistence on moving from a "single till". The second is the treatment of land and land costs in the aeronautical account. The arguments, especially on single till, have been extensively detailed in the IATA submissions, they are summarised below.

Single Till

The most important effect of single till on airlines and their passengers and consequentially the already suspect competitiveness of HKIA is that "***a dual-till approach is likely to lead to higher airport charges for the aeronautical side of the equation. The issue of single till versus dual till also involves the fundamental question of a trade-off between overall public interest in Hong Kong and the commercial interest of a privatized AAHK².***

In January 2004, with due consideration of the special position of HKIA within the SAR economy, IATA offered a pragmatic approach to the SAR Government on the question of the single till (Enclosure 1). That offer is yet to be fully addressed. This is despite the Government's request for Legislative Council empowerment of "step-in" rights to the aeronautical assets should the New Co fail and despite its stated willingness to accept a lower rate of return on the aeronautical assets.

² ibid APRC Page 4

The elements of a successful agreement with the airline industry are within the submitted Papers and Minutes of IATA/BAR/AAHK meetings on Economic Regulation. As there are several more meetings scheduled it is suggested that the Government be included in the Steering Group to allow satisfactory resolution of the exceptions in a timely manner.

Treatment of Land

The treatment of Land in the HKIA Annual Reports is confusing. Notes to the Annual Report, Para 9 (c) say that the land has been leased to AAHK for a nominal amount. This is assumed to be a “*peppercorn rent*” or a rent of such an immaterial amount that it does not need to appear in the accounts. Yet, in the table of Fixed Assets, Para 9 (a) it shows a depreciated amount of HK\$10.840 billion for the value of “Leasehold Land”. This is not a “*nominal amount*”. In addition to the annual depreciation, it requires a significant annual return equivalent to the cost of capital of that value. These costs largely fall within the “aeronautical till” thereby exacerbating HKIA’s cost to the market and to its regionally suspect competitiveness. Once again, it undermines the Government’s stated intent of accepting lower returns on the aeronautical charges. Given the recent fiasco surrounding the West Kowloon Cultural District Project and the shelving of the Link REIT IPO, it is suggested that the situation should be corrected.

IATA has been advised that the Government is yet to receive a financial return from the sale of land at the old Kai Tak airport. Given the improved financial conditions in the SAR, the Government could now consider selling the old airport land rather than potentially reducing control over 10% of SAR GDP through a sell down of its shares in the new airport. The Government will also have continuing returns from the increased value of Kowloon land due to removal of building height restrictions. Finally, the Government will be able to achieve large returns from the sale of corridor land along the Chep Lap Kok road and rail access route.

Given that the Government has obtained a satisfactory agreement with the owners of the new Hong Kong Disneyland Company for the treatment of, and returns on land, it begs the question why it cannot enter into a similar agreement or treatment of land with the parties to the aeronautical assets. The difference in arrangements is striking given that the Disney project will be less than 2% of GDP while the airport has been assessed at 10% of GDP³.

IATA believes that the Government should retain ownership and that the residual value of the land should be in its accounts and not in the AA’s. IATA also believes that the Government should seek any necessary additional finance from Kai Tak, Kowloon and the “corridor” land before it sells down shares in the new airport at Chep Lap Kok. Selling down the AA would amount to nothing less than selling 10% of the “*Crown Jewels*”.

The Government and the people should continue to receive the 1% depreciation on land from its desired aeronautical till but they should receive a 3% return on land from the commercial or non-aeronautical till; just as it has agreed with the Hong Kong Disney commercial venture. The difference could be that the amounts could be paid direct to the Government for what is in reality the cost of the reclamation of the airport land in a direct rent. The land would then be on the Government’s books exactly where LegCo and the people want it to be. It would allow a reduction in AAHK equity thereby increasing its effective returns. It would also allow the Government to obtain agreement with the airlines and underpin HKIA’s ability to maintain high quality award winning services. It would achieve its world standard aviation hub and make HKIA an icon in the region. However, most important will be the Governments ability to control the AA and its ability to be the engine for continued economic growth of the SAR.

³ http://www.edlb.gov.hk/edb/eng/papers/ue_panel/com_upload/E98/es1103cb1-117-e.pdf



**THE NEED FOR
ECONOMIC REGULATION OF THE
HONG KONG INTERNATIONAL AIRPORT**

**IATA SUBMISSION
TO THE
ECONOMIC DEVELOPMENT AND LABOUR BUREAU
OF THE HONG KONG SAR**

14 January 2004

**IATA SUBMISSION
TO THE
ECONOMIC DEVELOPMENT AND LABOUR BUREAU
OF THE HONG KONG SAR
ON THE
NEED FOR ECONOMIC REGULATION OF HONG KONG
INTERNATIONAL AIRPORT**

1. Introduction

The International Air Transport Association (IATA) is the trade association of the world's air transport industry, representing over 270 Member airlines, which carry 98% of the world's scheduled international air traffic. IATA is herewith presenting the views of its Member airlines on the need for economic regulation of the Airport Authority of Hong Kong (AAHK) and the key elements that need to be addressed in ensuring a successful regulatory regime for consideration by the Economic Development and Labour Bureau of Hong Kong SAR (EDLB), particularly in view of the proposed privatisation of Hong Kong International Airport (HKIA).

The Airline industry is of the view that privatisation of the airport should benefit not only the Government of Hong Kong SAR and the new owners of the privatised entity, but also the airlines, passengers and shippers. The industry is also of the firm conviction that in privatising such strategic infrastructure, the public utility nature of the airport and the role it plays in the development and air transport's contribution to Hong Kong SAR's overall economy should be given due consideration.

The airline industry is opposed to the conversion of a public monopoly into a private monopoly, which will result in the abuse of its position by its owners. The airlines are also concerned that privatisation could be taken as an opportunity for raising charges to the airline users. This concern does not simply relate to aeronautical charges. The concern covers other related fees that the AAHK charges e.g. franchise fees, the levels of which are already rather exorbitant. Making these fees too punitive would only serve to push up the costs to the airlines operating at HKIA as this would have the same effect as an increase in aeronautical charges.

Such concern is not without cause because the current charges at HKIA are already quite high. If we compare HKIA with other major airports in the region, which is more relevant than comparing with airports elsewhere in the world, the airport charges of HKIA are higher than Seoul, Taipei, Bangkok, Singapore, and Kuala Lumpur by 33%, 45%, 59%, 123% and 352% respectively. Obviously, any attempt to adjust charges at HKIA should be for reduction rather than increases.

As a result of severe competition and market demand for lower airfares and better quality of service, the yield (revenue per unit of activity) to the airlines has been declining over the past decade or more. During the past five years, the decline in yields to the IATA Member airlines on their international scheduled operations has

been around 3.4% per annum. This need for reduced airfares is further demonstrated by the rapid growth of the “No frills” carriers.

Therefore, the airlines need to continuously improve efficiencies and reduce operating costs. In this effort, all providers of services to the industry also have to ensure that they in turn improve their efficiencies and quality of service while reducing charges to the airlines.

The airline industry is of the view that Economic Regulation is one of the more transparent and effective ways of achieving this objective. In this regard, IATA supports the statement in Paragraph 15 of the ICAO document 9082/6 “ICAO’s Policies on Charges for Airports and Air Navigations Services” , which states:

“The Council notes that with the rapidly growing autonomy in the provision and operation of airports and air navigation services, many States may wish to establish an independent mechanism for the economic regulation of airports and air navigation services. Such a mechanism, the establishment of which in such circumstances is recommended by the Council, would oversee economic, commercial and financial practices, and its objectives could be drawn or adapted from, but need not be limited to, the following:

- i) Ensure non-discrimination in the application of charges.*
- ii) Ensure there is no overcharging or other anti-competitive practices or abuse of dominant position.*
- iii) Ensure transparency as well as the availability and presentation of all financial data required to determine the basis for charges.*
- iv) Assess and encourage efficiency and efficacy in the operation of providers.*
- v) Establish and review standards, quality and level of services provided.*
- vi) Monitor and encourage investments to meet future demand.*
- vii) Ensure user views are adequately taken into account.”*

Paragraphs 13, 14, 16 and 17 of the same document also provide further insight into the requirements for the successful regulation of a privatised airport.

In this document, IATA is presenting the views of the industry on economic regulation and some key aspects that need to be addressed in establishing the framework for economic regulation and determining the level and structure of charges.

2. Clear definition of the scope of the Airport’s business.

It is essential that a decision be made regarding the scope of the Airport’s business and be communicated to all stakeholders. In the view of the airline industry, all activities performed by the Airport or its agents that are required for the safe, reliable and efficient air transportation and commercial activities, linked directly or indirectly

to the air transport activity should be included within the scope of the airport business. Given the strategic importance of the airport to Hong Kong SAR and to International Civil Aviation, any high-risk non-aeronautical activities, failure of which could threaten the viability of the airport should be excluded.

3. The Appropriate Regulatory Regime

Economic regulation usually seeks to reproduce the desirable elements of a competitive market in a situation where competition is not possible. Airports are natural monopolies and thus, require some form of economic regulation.

There are many different methods of economic regulation in use across a range of industries around the world. At a simplistic level, the choice is between 'Rate-of Return' Regulation and 'Incentive' Regulation, perhaps the best-known version of which is known as RPI-X regulation.

a) Rate of Return Regulation

Under rate of return regulation, the company provides detailed information on the costs incurred in providing its services. The regulator reviews those costs, and if they are reasonable, the company will be allowed to recover them from their customers. It will also be necessary for the regulator to decide the asset value, depreciation and rate of return for the regulated company. The rate of return will reflect the cost of debt and equity for the regulated company. The revenue for a given year will be the asset value multiplied by the rate of return plus operating costs plus depreciation.

IATA does not support the use of a pure 'Rate of Return' regulation for Hong Kong for two reasons. Firstly, if the rate of return is set too high, then the company has an incentive to 'gold plate' its assets, and increase its capital expenditure inefficiently. Secondly, the regulated company has no incentive to reduce operating costs.

b) Incentive Regulation (RPI-X)

Under this system, the regulated airport is allowed to increase its revenue by the Retail Price Index less an efficiency factor (known as X). If the regulated company is more efficient than was assumed when setting the X factor, it is allowed to retain any savings as profit. If the airport is less efficient than was assumed when setting the X factor, it will make a loss. Therefore, RPI-X regulation provides the regulated company with an incentive to cut costs quicker than the forecasts underpinning its revenue control. In principle, the X factor can be set without reference to the costs of the regulated company. However, in practice, the regulator requires an understanding of the forecast costs of the regulated business.

Generally, where airports have been subject to overt economic regulation it has been under an RPI-X type regime.

Airlines generally understand and prefer ‘Incentive’ regulation as opposed to pure ‘Rate of Return’ regulation because, in essence, RPI-X aims to mimic the competitive market outcome by:

- Allowing for innovators to enjoy temporary benefits
- Providing an incentive to reveal attainable cost efficiencies
- Being forward looking with forecasts of potential productivity improvements whereas rate of return is backward looking and is based on historic costs
- Giving regulators more degree of freedom because of the range of factors that can go into X.
- Allowing scope for bargaining under RPI-X (which may lead to better outcomes)

3.1 The BAA’s London Airports ~ A good working model.

The most mature example of economic regulation of airports is in the United Kingdom, where BAA’s three London Airports have been regulated since their privatization in 1987. We consider this a good role model for Hong Kong.

In practice, economic regulation of BAA’s London Airports is a hybrid model of price- cap and rate-of-return regulation. The price cap comprises a RPI-X price cap applied in the form of an average revenue yield per passenger. Airport charges subject to the price cap are those associated with the landing, take-off, and parking of aircraft, and with the processing of passengers through the terminals. The procedure for calculating the price cap at designated airports under the single till comprises four main steps:

- a. An agreed program of capital expenditure for the airport is determined. In addition, based on consultation between the regulators, the airports, airport users and other interested parties, the regulator determines, for the coming five-year period, estimates of:
 - traffic and passenger numbers;
 - operational expenditure; and
 - commercial revenues (revenues from non-aeronautical services).
- b. The value of the airport’s asset base is derived, and an allowable risk-adjusted rate of return is determined by the regulator.
- c. The overall revenue required by the airport to achieve the approved rate of return is then estimated. The estimated commercial revenues are then subtracted from the overall revenue requirement to obtain the residual revenue requirement.
- d. The residual revenue requirement is what airports may earn from charges from the provision of aeronautical services under the price cap. The Xs, which are set by the regulator, are estimated to allow the airport to recover the residual revenue requirement.

As individual charges are not subject to the price cap, the airport operator has a degree of discretion with respect to the level of each individual charge and the relationship between them. When resetting the RPI-X price cap, the regulator adopts a single-till approach. Under the single till, future revenues and costs are assessed on an airport-wide basis to determine allowable average revenue yield per passenger. That is, the regulator takes into account not only the revenue generated from aeronautical services, but also the revenue generated by activities such as retailing, and the provision of rental property and other services to tenants and licensees. The cap is reset every five years by the regulators after an extensive review process.

We are seeking a single till structure that allows the airport to retain any commercial earnings that exceed the forecast for the regulatory period and do not impact on the level of airport charges for that period.

In this paper, it is not our intention to define the Value of X, as this requires a greater understanding of the regulatory regime that the Government of Hong Kong SAR would be stipulating and the business forecasts of the airport. IATA will present the airline industry views once the Government has made its recommendation.

4. Application of the Single Till

The concept of the single till is widely understood within international aviation regulation. The International Civil Aviation Organization (ICAO), who endorse the single till approach, in Paragraph 22 i) of ICAO Document 9082/6 provides a simple explanation of the single till:

“The cost to be shared is the full cost of providing the airport and its essential ancillary services, including appropriate amounts for cost of capital and depreciation of assets, as well as the cost of maintenance and operation and management and administration expenses, but allowing for all aeronautical revenues plus contributions from non-aeronautical revenues accruing from the operation of the airport to its operators.”

Airports Council International (ACI) has also accepted the single till concept as evident in the Joint ACI/IATA position on this matter given in Attachment 1.

IATA supports the retention of a refined version of the single till for a number of reasons.

a. Interdependency

It has long been accepted 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 – Hong Kong International Airport is no exception to this.

The interdependency has been highlighted by BAA, the operator of airports in the UK and internationally, in their recent annual reports:

“..... that the income from commercial activity enables the business to keep down changes to airlines – which is inevitably passed on to passengers in the fares they

pay – and invest in airport infrastructure. It is no accident that the UK is the only country in the world where major airport infrastructure can be provided at no cost to the taxpayer. We can only finance our capital investment program as a result of the revenues we earn by providing quality commercial services.” (BAA Annual Report 1998/99 p.20)

“By offering customers what they want, we can maximise commercial returns, making it possible to keep airlines charges low and invest in airport infrastructure.” (BAA Annual Report 1999/00 p.26)

It is reasonable to assume that in the absence of aeronautical services, there would be no market for non-aeronautical services such as retail concessions and car parking. Thus, aeronautical services are primary drivers for non-aeronautical services.

An example of interdependency outside of aviation is that between the value of retail leases at shopping centres and investments in adjacent car parking spaces. The more accessible is the shopping centre (i.e. the more car parking spaces that are available), the more visitors there will be to the centre and the more valuable will be the retail leases. Thus, many shopping centres do not charge for car parking or charge a nominal rate in order to entice customers into the retail portion of the centre.

In this context, it is also useful to note the UK Competition Commission’s findings, which state:

“Against those, at most, limited benefits, we see significant disadvantages from the dual-till approach. We believe it is difficult sensibly to separate commercial and aeronautical activities. BAA's rental and other commercial revenues at the three London airports would not be generated without aeronautical facilities-commercial and aeronautical facilities are better, therefore, in our view, and more realistically regarded as one business. Since the successful development of commercial revenues requires airlines to attract passengers to the airport, the benefits of commercial activities should also in our view be shared with airlines and airline users.”

b. Absence of a competitive environment for airports.

Airports are natural monopolies, thus their pricing behaviour is tempered by the lack of formal competition. It is IATA’s strong belief that if it were possible to place airports into a competitive environment, for example, if they had to regularly tender to provide airport services to airlines, they would not treat aeronautical and non aeronautical as two distinct and separate income streams. Instead, a rational airport provider is most likely to promote aeronautical pricing solutions that would increase passenger throughput at their airport in order to maximise their non-aeronautical revenue. Thus they would use income generated from non-aeronautical services to support aeronautical charges to encourage additional passenger throughput.

This is common practice in other industries where product pricing is determined by different revenue generators, for example, in the mobile phone industry, the price of handsets is priced below cost in conjunction with long-term line rental agreements.

Good examples of this in practice are the 2 Belfast airports – Belfast City Airport (BHD) and Belfast International Airport (BFS) – which do compete directly. BHD has adopted a single till approach as a means to offer competitive pricing versus its more established competitor (BFS).

c. Simplicity

The single till has long been recognised as a simple system to administer, as there are no complex or contentious cost allocation issues between aeronautical and non-aeronautical activities to deal with. A dual pricing till system will need to be detailed and robust oversight by a regulator required to ensure that aeronautical activities are not unjustly burdened with costs that are not attributable to the services provided and to ensure that the costs of common use space and resources are allocated reasonably. A further factor that complicates the accurate determination of aeronautical costs is in determining the actual infrastructure requirement and operating costs. For example, would the reduced level of investment need, if the airport was only providing aeronautical and aeronautical related services have resulted in a reduced risk level? Would the terminals require the same number of public amenities, public lifts, escalators and moving walkways? By what percentage could the operating costs be reduced?

Therefore, the monitoring of the ring-fenced revenue streams and associated expenditure would not be without on-going costs and considerable effort would have to be made ensuring compliance and enforcement.

d. Under-investment in aeronautical resources

Under a dual till approach, airports will have to make continued capital investment decisions, given there is an implicit scarcity of financing resources within all companies, capital will be allocated to fund resources that provide the highest economic return. Non-aeronautical investment as an unregulated source of income will generate higher returns when compared to aeronautical investment. Thus, future investment decisions under a dual till environment will be weighted to non-aeronautical infrastructure. This could lead to an imbalance in service levels between the two areas and ultimately could compromise the integrity of the aeronautical infrastructure.

e. IATA's Pragmatic Approach to Single Till Pricing

Recognising that the airport is an indivisible enterprise, a common sense approach to pricing aeronautical service with analytical merit is the single till approach. Under the single till approach, aeronautical charges are effectively set to recover the costs of providing aeronautical services less any excess profits the airport operator achieves from non-aeronautical services. In this way, it treats the airport

business as an indivisible enterprise and recognises the interrelationships between aeronautical and non-aeronautical investments, operating costs and revenues.

Although interdependencies are recognised, it has been argued that the single till approach may provide weaker incentives for the airport operator to invest in improvements in its non-aeronautical assets. However, under single till, the aviation charges are usually set by considering budgeted cost and ancillary income streams, which will be discussed with the users, higher results thanks to performing better than agreed (lower cost, higher ancillary income) remains with the operator, with the compliments of the users until the following regulatory review when the single till is re-set. This provides an incentive to the airport to develop non-aeronautical revenue whilst at the same time ensuring that in the longer term airlines share in the benefits of the fact that its they who bring the retail spending power of passengers to the airport.

As evidence of this, retail floor space at BAA's three London airports increased by about 45,000 sq. metres (80%) over the last 7 years – a growth far in excess of passengers numbers. This was done under a single till environment – so BAA quite clearly did not feel that the single till gave them no incentive to increase commercial facilities. In addition, almost 80% of BAA's profits in the last two years have been from commercial activities. This equates to about £400m.

In their most recent review of the BAA structure, the UK competition commission in their reports to the UK CAA found no evidence of under-investment as a result of the single till, so the dual till, it was argued, was to solve a perceived problem that had not actually occurred.

The conclusion of the review was that, given the increase in the profitability of the BAA airports that would result from the dual till, at the expense of higher charges to airlines and higher fares to their passengers, the reasonable interests of users to the airports are better served by the single till than by the dual till. Hence, it would be unreasonable and inappropriate to allow prices to be determined by the application of dual till.

5. Definition of aeronautical, aeronautical-related, and non-aeronautical activities.

In defining aeronautical, aeronautical-related and non-aeronautical activities, the following are presented for consideration. It is stressed that the list is by no means exhaustive and may need to be amended at times to adapt to changing circumstances.

Aeronautical services can be defined to include:

- (a) aircraft movement facilities, meaning any of the following:
 - (i) airside grounds, runways, taxiways and aprons;
 - (ii) airfield lighting, airside roads and airside lighting;
 - (iii) airside safety;
 - (iv) nose-in guidance;
 - (v) aircraft parking;
 - (vi) visual navigation aids

- (vii) aircraft ramp services including short-term maintenance; and
- (viii) aircraft refueling services.

(b) passenger processing facilities and activities, meaning any of the following:

- (i) forward airline support area services;
- (ii) aerobridges and airside buses;
- (iii) departure lounges and holding lounges (but excluding commercially important persons lounges);
- (iv) immigration and customs service areas;
- (v) security systems and services (including closed circuit surveillance systems);
- (vi) baggage make-up, handling and reclaim;
- (vii) public areas in terminals, public amenities, public lifts, escalators and moving walkways; and
- (viii) flight information display and public address systems.

Aeronautical-related services can be defined to include:

- (a) landside vehicle access to terminals (including areas of close proximity to terminals which facilitate access to terminals, such as short term parking or stopping areas for buses and hire cars);
- (b) landside vehicle services, including:
 - (i) public and staff car parking (but not valet parking); and
 - (ii) taxi holding and feeder rank services on airport;
- (c) check-in counters and related facilities;
- (d) aircraft refuelling services and related infrastructure; and
- (e) aircraft light and emergency maintenance sites and buildings.

Non-aeronautical activities are those activities that are undertaken by an Airport Operator, which do not fall within the definition of Aeronautical and Aeronautical-Related activities as defined above.

6. Cost allocation: related assets and operating costs.

As has been discussed earlier in this submission, cost allocation between, aeronautical, aeronautical related and non-aeronautical activities would not be a major issue provided the single till concept is applied. However, if a dual till or multi till concept is established, the airline industry would require detailed information regarding the cost allocation methodologies used and the performance of an independent audit acceptable to the airline industry with its full participation in the process.

On this issue, the UK Competition Commission has stated that:

“It is also difficult, in practice, to allocate either investments or operating costs between aeronautical and commercial activities. To the extent that some of the judgements that have to be made are arbitrary, future disputes about cost allocation could also harm relations between the airport and its users.”

Even within the single till concept, cost not allocable to civil aviation, such as the costs incurred in view of functions that are the prime responsibilities of Government as immigration, customs, quarantine and security, should be removed from the charges cost base. The joint ACI/IATA position paper on this matter is given in Attachment 2.

This airline industry position is in line with ICAO Policies on charges as stated in Paragraph 22 iv) of ICAO Document 9082/6, which states that:

“An allocation of costs should be considered in respect of space or facilities utilized by government authorities.”

IATA is of the view that costs of these functions should be paid for by the Government, particularly if it would be taxing the airport post commercialisation.

7. Asset Valuation.

The capital base will be highly sensitive to the accounting methods adopted for valuing assets. Furthermore, changes to such accounting methods during a review period can have a significant impact on the assets thus re-valued.

Care needs to be taken regarding reclassification of land as investment property. Investment properties may be valued by some airport authorities on an “open market” (capital value being calculated as a multiple of rent) thereby producing a higher market value.

Certain airport authorities may attempt to re-value their asset bases with the intention of charging depreciation on the new asset values, even when the assets in question may have been already fully depreciated.

It is also necessary to be cautious about the risk of inclusion in the asset base of both the assets during the course of construction and the capitalisation of interest associated therewith. To allow both capitalisation of interest and a rate of return on assets in the course of construction results in double counting of the opportunity cost of capital during that period.

If the asset base is not recorded in the balance sheet on the basis of an historic cost valuation (that is, if a current cost methodology is employed), the need to link the asset base to a stable cost/price index is essential to avoid fluctuations in the capital base valuation due to unforeseen economic circumstances and the resultant distortions of permitted rates of return.

In the case of HKIA, IATA does not anticipate any major issues as all assets are relatively recent and hence, applying historical values would be acceptable to all parties.

8. Policy on the treatment of land:

Land is an asset, which does not have a limited life. Therefore, the land used by an airport should not be taken into account in calculating return on capital or depreciation. Land should be treated as an investment by the airport owner, which does not yield a return, but may be disposed of (if the airport closes) at a significant capital gain. Any such capital gain should be applied towards the capital cost of the replacement facility.

In recent times, some airports have been proposing an opportunity cost approach to determine the value of existing land to be used in constructing the asset base, which then results in higher returns for the airport investors at the expense of the users of the airport. IATA considers that this approach is flawed.

In most countries, due to environmental protection and other related regulations, land used for new airport facilities are those that do not have any other useful purpose. Hence, the initial value of airport land is the least costly in the region. Due to the economic activity and the provision of better access in most cases, land prices around airports appreciate with time. It should be recognised that this is a result of activities by both the airport and the airlines. Therefore, it is incorrect for airports to re-value existing land based on current market prices, prices which the airport has not paid for. It is even worse when one party uses the benefits of such increased value to the detriment of the other contributing party.

IATA's view is that the land in current use by AAHK should be zero valued. We understand that that is the case at present, where the land has been provided to the airport on a nominally priced lease. We support the continuation of this policy.

The reclaimed land would be available to the Government for disposal once the airport ceases its operation at the current location. Hence, given the rate of growth in land prices, and therefore the opportunity for the Government to make a significant profit at the end of the airport's operation, the airline industry is of the view that, when privatizing the airport, the Government should consider absorbing the land reclamation costs, thereby reducing the pressure on the new owners of AAHK.

9. Rate of Return.

In deriving the appropriate cost of capital and applicable rate of return, due regard should be had to:

- the monopolistic, relatively low-risk position of the airport authority; and
- the fact that an airport has a responsibility to the well being of an area's overall economy – overpricing its services affects a much larger constituency than its immediate users.

It has always been the airlines view that there was no need for HKIA aeronautical charges to be set at such a high level at the date of airport opening. The current charges, even though they have been reduced by 15% in 1999, are still higher than necessary and there is room for further reduction.

The question or debate as to what approach should be taken to recover the investment made by the investor (HKSAR Government) had been the highlight of the discussions held between the airlines and the Government and Provisional AA, prior to - and after - the opening of the airport. At that time, making a 5% return was the basis of the discussion. While the charges were eventually finalized at the current level, it is the IATA view that:

- a. The land for HKIA including reclamation thereof for the purpose of operating a viable air transport infrastructure would be available to the Government for disposal once the airport ceases its operation at the current location. This allows, given the rate of growth in land prices, the opportunity for the Government to make a significant profit at the end of the airport's operation.
- b. The realty value of such land should therefore, not be included in the asset base of the project when compiling the rate of return. The airlines understand that that is the case at present, where the land has been provided to the airport on a nominally priced lease. We support the continuation of this policy.
- c. The airlines further understand that the present land cost as in the books of AAHK is basically the land reclamation cost. For the reason as stated in point a) above, we believe firstly, that such cost should not be included in the base upon which the rate of return is calculated and to reduce the pressure on the new owners of AAHK, the Government should consider absorbing the land reclamation costs when privatizing the airport.
- d. The rate of return achieved so far, as per AAHK for the year 2002/2003, was 1.4% on net asset or on Government Investment (HKD 36.6 billion), which includes a large sum of land reclamation cost of approximately, HKD 11 billion (depreciated to 31st March 2003). If we were to reduce the net asset by the amount of the land reclamation cost, the return made by AAHK in 2002/2003 would have been 2%.
- e. The normal basis of evaluating the return on investment in any capital project is to take into account the cash inflow during the economic life of the project plus any residual value. If we were to project an aggregated rate of return using the entire life of the airport, it is envisaged that the rate of return will be very healthy, as probably most of the current fixed assets will be largely depreciated in 30 years time as per the current AAHK schedule. Therefore, it is important that we assess the rate of return for the entire life of the airport.
- f. The airport is currently at half of capacity. Future growth will definitely contribute to a much higher rate of return when the assets are better utilized.

- g. Weighted Average Cost of Capital (WACC) is the standard approach to calculate the required rate of return. However, prior to such attempt, it is important that the current equity structure be reviewed to ensure a more viable debt to equity ratio. We consider it more equitable to have a balanced mix of equity and debt to avoid distorting the WACC by a higher risk premium associated with equity risk.
- h. The risk of investment in HKIA is low given the Government remains its major shareholder. We expect a very low risk premium for both debt and equity over the equivalent asset type in the market.
- i. In the event that AAHK is unwilling to share the traffic risks with the airlines, the risk free rate should apply.
- j. In addition to making reference to WACC as an indicator of rate of return, reference should also be made to the use of RPI-X (or CPI-X) as a means to safeguard against assets being “gold-plated” as discussed in Section 3 of this submission.
- k. It was understood that a 5% ROR was used in deriving the current airport charges. In the case of AAHK post IPO, the ROR should be set taking into account the social and economic value of HKIA for the development of the economy and prosperity of Hong Kong.

10. Transparency and the provision of financial and operational information to the airlines.

In the process of consultation with users on charges for the airport, the underlying philosophy is, transparency of information and the rationale of decisions. Transparency is the means of facilitating knowledge, assessment and opinion on what is happening within the airport. The regulatory authority should ensure that the users are provided with adequate information on major developments at the airport, rational for any charge setting proposal, charge setting formula and the method used to establish the values used in the formula.

Airport Operators should include, as part of any accounting information provided to the users, full and detailed documentation of the accounting principles and policies used to prepare that information.

A pro-forma statement developed that lists the basic information airlines wish to have during a consultation process is given in Attachment 3. The periods upon which information is required are the actual of the two years preceding the year in which consultations take place, estimates for the year in which consultations take place and the forecasts for the subsequent five years.

11. A business plan with projection into the next 5, 10 and 20 years.

In order to allow better understanding of the airport’s business situation, a long term high level business plan of the airport with forecast projections of infrastructure

development, investments, and financial statements should be provided to the airlines during the consultation process, while a detailed capital expenditure plan covering the five years under review should also be provided. The five-year plan should also be supported by a robust traffic forecast. While the capital expenditure affecting aeronautical charges should be first agreed with the airline industry, its non-implementation or partial implementation should result in an automatic reduction of charges to the airlines.

12. Standards and Service Quality.

In order to ensure that the service to be provided by a privatized AAHK will not be compromised for the sake of pursuing higher or even excessive profits, there must be some protection against deterioration of service standards. AAHK should commit to a service charter that set out the general performance principles, criteria and measures to be adopted. The suggested guidelines are as follows:

Performance principles and criteria

Performance principles to be observed should include:

- (a) maintain and operate a secure, safe and efficient airport,
- (b) provide a comfortable and friendly environment to the travelling public,
- (c) continue to improve airport facilities and aviation services wherever justified and in accordance with plans agreed with airlines,
- (d) ensure that a high standard of cleanliness is maintained in public areas and facilities,
- (e) continue to maintain and improve airport facilities and aviation services for special needs passengers,
- (f) ensure that all aviation services comply with occupational health and safety standards,
- (g) respond promptly to airlines' enquiry regarding aviation services and facilities, and
- (h) allocate aviation services and facilities to airlines in a mutually beneficial and equitable manner.

Measures

Three types of measures should be adopted. These are:

i) Performance

These measures relate to the operating characteristics of systems where poor performance may lead to aircraft delay. The measure should be defined as a percentage of demand processed within a fixed time.

ii) Availability

These measures relate to those services where delays can arise as a result of capacity not being available. The measure should be defined with in

terms of the percentage of time that the asset's services are available or a percentage of the total volume processed by the assets in question.

iii) Quality of service survey

The service charter should provide for AAHK, at least once a year, to survey:

- (a) a representative sample of all passengers, arriving and departing, to determine the level of satisfaction across a range of performance measures, and
- (b) major users of the airport in relation to the aviation services and facilities provided to them.

Suggestions of performance and availability measures to be rated for passengers may include:

- (a) check-in waiting time in check-in queue,
- (b) Government inspection –
 - waiting time in inbound immigration queue,
 - waiting time in Customs queue, and
 - waiting time in outbound immigration queue,
- (c) security clearance – waiting time at baggage x-ray area and length of time security screening takes per passenger,
- (d) gate lounges –
 - availability of seating in departure lounge,
 - comfort of seating in departure lounge,
 - cleanliness of seating in departing lounge, and
 - size of departure lounge for number of people using it,
- (e) baggage –
 - waiting time at baggage reclaim area,
 - size of baggage reclaim area for number of passengers, and
 - ease to find appropriate carousel,
- (f) baggage trolleys – ease of finding baggage trolleys,
- (g) flights information display and signs – general satisfaction with flight information display and signs,
- (h) washrooms – terminal's overall standard of washrooms,
- (i) car parking –
 - waiting time to get in and out of the car park,
 - overall standard of car parking, and
 - availability of car spaces,
- (j) airport access –
 - suitability of area for curbside car pick-ups and drop-offs,
 - space provided for curbside car pick-ups and drop-offs,

- suitability of area for taxi pick-ups and drop-offs,
- space provided for taxi pick-ups and drop-offs,
- suitability of area for bus pick-ups and drop-offs, and
- space provided for bus pick-ups and drop-offs.

Additional performance and availability measures to be rated for major users may include:

- (a) landside infrastructure,
- (b) aerobridge availability,
- (c) taxiway availability, and
- (d) runway availability.



**PRIVATISATION
OF
THE AIRPORT AUTHORITY**

**IATA SUBMISSION
TO THE
ECONOMIC SERVICES PANEL
LEGISLATIVE COUNCIL OF HONG KONG
SPECIAL ADMINISTRATIVE REGION**

31 January 2005

References:

- A. Legislative Council, Panel on Economic Services – Report on port and airport management, airport privatisation in April 2004. LC Paper No. CB (1) 2216/03-04
- B. Privatisation of Airport Authority. IATA Submission to Legislative Council Economic Services Panel Hearing, 31 January 2005 (Attached)
- C. The Need for Economic Regulation, Hong Kong International Airport, Submission to Economic Development and Labour Bureau, IATA 14 January 2004 (Attached)

reducing charges to the industry. For HKIA it is especially so because of the immediate impact on the SAR's economic well being.

The airline industry is of the view that Economic Regulation is one of the more transparent and effective ways of achieving efficiency and market equivalent prices. In this regard, IATA supports ICAO's Policies on Charges for Airports and Air Navigations Services that recommends that States may wish "to establish an independent mechanism for the economic regulation of airports and air navigation services." IATA has previously presented its views, including aspects of the joint recommendations of the Airports Council International in its submission to EDLB on 14 January 2004. The submission is attached for the Panel to review. In essence the main points of the IATA recommendations are:

- 1. An Appropriate Regulatory Regime.** Economic regulation usually seeks to reproduce the desirable elements of a competitive market in a situation where competition is not possible. Airports are natural monopolies.
- 2. Incentive Regulation (CPI-X).** Under this system, the regulated airport is allowed to increase its revenue by the Consumer Price Index less an efficiency factor (known as X). If the regulated company is more efficient than was assumed when setting the X factor, it is allowed to retain any savings as profit.
- 3. Application of the Single Till.** The concept of the single till is widely understood within international aviation regulation. ICAO endorses the single till approach.
- 4. Policy on the Accounting Treatment of Land Value.** Land is an asset, which does not have a limited life. Therefore, the value of land used by an airport should not be taken into account in calculating return on capital or depreciation.
- 5. A Business Plan with Projection into the Next 5, 10 and 20 Years.** A long term high level business plan of the airport with forecast projections of infrastructure development, investments, and financial statements should be a Government/public reviewed plan reflecting the airports position in Hong Kong SAR's future economy.
- 6. Standards and Service Quality.** In order to ensure that the service to be provided by AA will not be compromised for the sake of pursuing higher or even excessive profits, there must be some protection against deterioration of service standards. AA should commit to a service charter that sets out the general performance principles, criteria and measures to be adopted, see the Attached IATA EDLB Submission detail.

CONCLUSION

The airline industry is opposed to the privatisation of natural monopolies such as airports without adequate safeguards to prevent any possible abuse of market power. IATA recommends incentive regulation to balance and protect all stakeholders. In addition the AA must be encouraged to produce efficiencies and lower costs, not only for airlines but also for the future economic well being of the Hong Kong Special Administrative Region. Such reductions can be achieved on a continuous basis stimulated through AA's internal management capabilities combining with the positive assistance provided by effective incentive economic regulation.



**SUBMISSION TO THE
ECONOMIC SERVICES PANEL
LEGISLATIVE COUNCIL, HONG KONG SAR
PRIVATISATION OF THE AIRPORT AUTHORITY**

The Airline industry is of the view that the privatisation of Hong Kong International Airport (HKIA) should benefit not only the Government of Hong Kong SAR and the new owners of the privatised entity, but also the people, the Airport Authority (AA) and staff, airlines and their passengers and those aviation related businesses serving Chep Lap Kok. They are all stakeholders whose needs and aspirations should be addressed in a balanced manner. The industry is also of the firm conviction that in privatising such strategic infrastructure, the public utility nature of the airport, the role it plays in the development of, and air transport's contribution to, Hong Kong SAR's overall economy should be given primacy of consideration. All stakeholders will need to compromise some of their aspirations if they want HKIA to continue to grow and serve the SAR community.

The airline industry is opposed to the conversion of a public monopoly into a private monopoly in any manner that could allow the abuse of its market power. The airlines are also concerned that privatisation could be taken as an opportunity for raising charges to an industry already in a critical financial state. This concern does not simply relate to aeronautical charges. The concern covers other related fees that the AA charges e.g. franchise fees, the levels of which are already rather exorbitant. Having punitive fees only serves to push up costs to airlines. Recent Press reports have already noted the slip in cargo handling competitiveness viz other regional seaports; similar risks are ahead for aviation unless the AA can achieve ever-improving efficiencies and remain competitive.

Such concern is not without cause because the current charges at HKIA are already quite high. If we compare HKIA with other major airports in the region, which is more relevant than comparing with airports elsewhere in the world, the airport charges of HKIA are higher than Seoul, Taipei, Bangkok, Singapore, and Kuala Lumpur by 33%, 45%, 59%, 123% and 352% respectively. Obviously, any attempt to readjust charges at HKIA should be for reductions rather than increases. Current prices, let alone any possible future increase will affect long-term economic growth in Hong Kong SAR.

As a result of increasing competition and market demand for lower airfares as well as better quality of service, the yield (revenue per unit of activity) to the airlines has been declining over the past decade or more. During the past five years, the decline in yields to the IATA Member airlines on their international scheduled operations has been around 3.4% per annum. Therefore, airlines need to continuously improve efficiencies and reduce operating costs. In this effort, all providers of services to aviation also have to ensure that they in turn improve their efficiencies and quality of service while continually

IATA
Airport Charges Comparisons
and
Submission to Hong Kong Special Administrative Region
Legislative Council
Economic Services Panel

29 April 2005

Executive Summary

The Economic Services Panel (ESP) of the Legislative Council (LegCo) of the Hong Kong Special Administrative Region (SAR) questions on airport prices and charging comparison mechanisms is similar to the Economic Development and Labour Bureau (EDLB) request for IATA, the Board of Airline Representatives (BAR) and the Airport Authority of Hong Kong (AAHK) to develop an airport cost comparison model. This comparison and submission seeks to answer both party's questions and provides recommendations for LegCo in their deliberations.

This study has found that there have been three archetypal comparisons.

- Airport initiated reviews that generally focus on airport revenue.
- Airline reports some of which focus on airline costs. and
- An international study of averages that is a broad indicator of global airport costs but is not relevant for regional or airport-to-airport comparisons.

Minor differences between the reports have occurred due timing and exchange rate variations. Medium size differences have occurred because of variation in the type and or model of aircraft chosen in the studies. For example, in late 2003, IATA chose the B737-400 medium weight (64 tonne) aircraft. In early 2005, EDLB/AAHK used the now more common medium weight A320 (73 tonne) aircraft. Both studies use the B747-400 as their heavy weight aircraft. The global study of the TRL Laboratories UK uses an average of 10 passenger jetliners that vary from 52 to 397 tonnes, some of which are negligible or even non-existent in Hong Kong International Airport (HKIA) operations. The IATA updated comparison study in this report establishes parity with EDLB/AAHK by using the medium weight A320 aircraft as well as the standard heavy B747-400.

A significant difference between the IATA and EDLB/AAHK studies has occurred because the latter does not include the then HK\$80, now HK\$120 per passenger departure tax at HKIA. Whilst the Tax may not be part of AAHK's income and may well be a fiscal policy decision of the Hong Kong Government, it non-the-less directly influences the passenger and the market. The broad responsibility of LegCo's study is that of relativities for the passenger, the market and the future of the SAR economy. To exclude such an impost is to deny the real cost of airport operations and its affect on market competition and future growth of the airport.

The elasticity of demand of air travel in the Internet era is such that any threat of charges increases, let alone actual rises, will stifle growth and will affect the market. The initial call

for the Partial Privatisation of AAHK was made after the 1997-1998 East Asian economic crisis when the SAR economy had suffered prolonged stagnation. It was in context with the Government's decision to recover HK\$6bn in capital from their airport investment. It was more than likely the fiscal reasoning for raising the airport departure tax by 50% to HK\$120.

In addition to adverse market levels, IATA has found that the structure of imposts at HKIA does not fully reflect the international policy of transparency of charges and the user pays principle. IATA is calling for a change in the structure of the charges to reflect these ideals.

When the Government announced its intention to investigate an IPO of AAHK, their financial advisors immediately announced that HKIA would need substantial increases in aeronautical charges for a successful IPO. The justification was a spot analysis of a less than 2% return on investment on AAHK's last (2003) reported financial statement. LegCo should bear in mind that an extremely young airport declared the 2% return when it had high depreciation amounts in what was the regions worst financial crisis.¹

Financial advisors to EDLB and AAHK are still touting the need for Charges increases at HKIA. There has been some moderation in their calls with the latest statement saying HKIA *may not need substantial increases in charges* but none the less leaving and/or giving the impression that increases are still required. Yet, statements as recent as 17 February this year indicate that AAHK will declare a profit of around HK1bn year-end 31 March tripling the last years SARS affected profit and doubling the earlier quoted return to around 4%.²

Given that such a young airport as Chep Lap Kok with;

- An AAHK/IATA agreed growth rate of 5% to 6% per annum for the next decade,
- in an economy that grew at 8.1% last year and with only a 1.5% inflation rate,
- in a region with double digit growth and increasing passenger access to more China Mainland cities,
- with decreasing depreciation amounts and no major aeronautical investment due for at least five years, and

with a Government who,

- has advised that it is prepared to accept a lower return on the aeronautical assets of AAHK, and who has
- requested that LegCo empower it to compensate investors should there be a requirement to retake/resume the aeronautical assets of the company,

it strains incredulity that the financial advisors had completed an in-depth analysis at the time of their provocative statement that aeronautical charges need to rise. Nor it would appear, given the increase in growth of the economy and HKIA passengers, have they gone back to EDLB and AAHK to review their statements.

In B747-400 operations, HKIA's costs are still 34% more expensive than at Incheon, 64% more than Taipei, 84% more than Singapore and Bangkok, and 199% more than at Kuala Lumpur. For A320 it is 41% (ICN), 105% (TPE), 73% (BKK), 112% (SIN) and 129% (KUL) respectively. The challenge is to address HKIA's competitiveness.

¹ Five years into the asset life of infrastructure at an airport, that varies from 25 to 50 and up to 100 years.

² AAHK CFO Dr Raymond Lai, Capital Markets Forum, Hong Kong 17 February 2005

“...The good signs in the Hong Kong economy are equally evident. After the 1997-98 East Asian economic crisis, the economy had suffered prolonged stagnation. It was showing signs of bottoming out in 2003 when along came the SARS crisis. But, from late 2003 on, the economy has recovered strongly.

The economy grew by a staggering 8.1 per cent last year. This is real Asian tiger growth. For an advanced and rich economy such as Hong Kong's, it is not sustainable, but it indicates a sharp and healthy recovery from recession.

This year, the economy is expected to grow between 4.5 and 5.5 per cent, which will still put it at the top of the growth rates for rich economies. Inflation is expected to be about 1.5 per cent, but given the deflation of the past few years, the markets will be delighted with a positive inflation number.”³

The economic background, potential growth and Government willingness to accept aeronautical returns with a community focus as well as a willingness to underpin investors assets clearly demonstrates that EDLB could agree a 10% reduction in aeronautical Charges before the IPO. Given the massive change in direction of the SAR economy post the Asia Financial and SARS crises the Government should also consider reducing the Departure Tax back to HK\$80 per passenger. This is necessary, especially if the Government wishes to make HKIA a more competitive airport in the region.

IATA policy is to support any Governments right to decide ownership of its aeronautical assets and will support airport privatisation as long as it:

- is not just about raising money,
- brings efficiencies and savings, and
- supports all stakeholders including passengers, the airlines, the airports, the investors and the people with a long-term economic point of view.

The above recommendations, detailed in the submission, Will allow:

- Industry to conclude an agreement and have a three-year pricing mechanism in place before the Government finalises its submission to LegCo for an IPO of AAHK.
- A three-year pricing agreement that will be good governance and a more transparent manner in which to go the public to seek funds. and
- Investors to have more certainty to their investment both in pricing terms and in the knowledge that IATA and the airline industry were working together with Government and AAHK for maximum achievement and efficiency in HKIA operations.

This will then allow, together with an AAHK/industry agreed infrastructure investment plan, service level agreement and regulatory regime, the best possible internal outcome for the Partly Privatised airport company the opportunity to grow. Such agreements will increase investor dividends and give the best possible return for the Government and people of the Hong Kong SAR.

³ Hong Kong: “Downtime to Boomtime”, The Australian, 20 April 2005;
http://www.theaustralian.news.com.au/common/story_page/0,5744,12837945%255E39918,00.html

Introduction

IATA is a worldwide association of international airlines whose some 270 members carry nearly 95% of the world's internationally scheduled air traffic under the flags of some 135 nations. Because of this unique position, IATA is often called upon for comparisons of airport and Air Navigation Service provider charges. When asked to do specific comparisons such as for the Legislative Council Economic Services Panel (LegCo ESP), IATA takes the airports own published charges figures plus significant other charges, taxes and substantial or unique airport fees to complete the study.⁴

Where there are significant differences that may be outside of normal airport charging methodologies then they may also be included. Such a review is necessary to obtain a true cost comparison for both the airlines and passengers. Total cost is relevant where users are considering competitive pricing of airports relative to others rather than more specific questions of what the airlines pay or what an airport receives in income. For market relativity, IATA compares total cost using the two most common medium and heavy international aircraft types that operate in that region and/or to those airports. IATA uses the exchange rates valid at the time of the assessment. IATA believes that this kind of comprehensive study is what the LegCo ESP is seeking to understand and review. IATA understands that LegCo requires a total picture of the Hong Kong International Airport's (HKIA) position viz-similar studies of other airports in the region.

Other Agencies and Studies

Other agencies may take a different view. For example, the well-known and respected Transport Research Laboratory (TRL) Review of Airport Charges of 50 of the largest airports takes a necessarily different view. It attempts to cover the entire globe in one simple synopsis. Every charge in the TRL report is what is generally common to all 50 airports; it does not record the extraordinary even if they are significant and/or relevant. It also has a predominance of European, North American and Australasian airports so it may not always be relevant to any one particular market. The TRL methodology is:

"...The Index of Charges is calculated from the charges which would be imposed on a sample of eight different aircraft types making one landing and one departure at each of fifty airports worldwide. The aircraft vary in size from around 110 seats (the B737-500) to around 400 seats (the Boeing 747-400), and the sample is intended to cover a range of types commonly used on international services around the world."⁵

The TRL aircraft types currently vary from 52 tonnes to 397 tonnes and from an assumed average capacity of 85 to 271⁶. TRL also varies the types with time. Each aircraft Maximum Take Off Weight (MTOW) and assumed average passenger numbers for the eight types are then added. The totals are then costed for one landing and one take off and placed in the comparison. There is no allowance for either the varying numbers of each aircraft type at any particular airport nor is there an allowance for the total weights of the classes of aircraft that may operate at each individual airport. The TRL study contains some aircraft that are irrelevant to HKIA operations. The TRL study is an average of averages and only a broad

⁴ As reported in Department of Civil Aviation Aeronautical Information Publications and listed in the IATA Airport and Air Navigation Services Charges Manual

⁵ TRL *Review of Airport Charges 2003, The Index and Our Methodology*, Page 1. Dated September 2003

⁶ *ibid.* Table 16, page 9.

indicator of relative differences over some very different economies. It is not definitive enough for direct airport-to-airport comparisons, especially if it involves discussions on pricing. It is aggressively used if any one particular airport is lower in the order than its comparator.

A true economic comparison of airport charges would most likely use Purchasing Power Parity (PPP) of the costs, especially if the comparison was between varying economies. The TRL report uses Special Drawing Rights (SDR) after converting local currencies to either Euro or US Dollars. This is very reasonable considering the worldwide scope of their studies. IATA uses US Dollars (outside Europe) for reasons of commonality within the airline industry. This includes; aircraft leasing costs, foreign loan borrowings and fuel and passenger travel costs in different countries that are all significantly influenced by and/or pegged to the US Dollar. This is especially valid in Asia and in any comparison between Hong Kong and Singapore. Re-conversion to a base currency e.g. Hong Kong is instantly available.

As indicated above, the TRL report covers 50 of the major international airports of the world. It is an average of averages and should not be used for direct airport-to-airport comparisons.⁷ It does not cover any exceptional costs that an airport or country may use as an additional income, levy or rent collection mechanism. "Taxes" levied by Governments as opposed to passenger "fees" or "levies" can also vary between public, corporatised and private airports, yet they are all imposts that affect the aviation market and each airports relative position.

Some airports can have restrictive trade practices that do not allow on-airfield competition of ground handling services or fuel supply companies thereby driving up airline costs. Others have competition among the suppliers but charge relatively high airport access, franchise or fuel throughput levies, fees and charges. None, of these extraordinary imposts are recorded in the TRL study, nor are they included in all but a full economic study. But once again, these additional costs are passed onto to airlines and passengers.

Additional costs do affect airline behaviour despite repeated statements by airports and Governments as to the insignificance of airport and ATC charges to airline operations. The most recent example was when British Airways and Qantas changed their Asian hub from Bangkok to Singapore citing extraordinary costs as a significant factor in their decision. The additional costs were not necessarily the nominal listed costs but many hidden imposts of which just a few have been included at Enclosures 2 and 4.

IATA Submission to EDLB January 2004

The IATA submission to EDLB of 14 January 2004 listed a regional comparison of the airport landing fees charged to airlines at Bangkok (BKK), Singapore (SIN), Taipei (TPE), Incheon (ICN) and Kuala Lumpur (KUL) that were valid in late 2003. The relevant paragraphs are:

"...The Airline industry is of the view that privatisation of the airport should benefit not only the Government of Hong Kong SAR and the new owners of the privatised entity, but also the airlines, passengers and shippers. The industry is also of the firm conviction that in

⁷ An airport supporting long range aircraft destinations and/or to vastly different markets will have on average heavier versions of each aircraft type and different opportunities for duty free etc.

privatising such strategic infrastructure, the public utility nature of the airport and the role it plays in the development and air transport's contribution to Hong Kong SAR's overall economy should be given due consideration.

The airline industry is opposed to the conversion of a public monopoly into a private monopoly, which will result in the abuse of its position by its owners. The airlines are also concerned that privatisation could be taken as an opportunity for raising charges to the airline users. This concern does not simply relate to aeronautical charges. The concern covers other related fees that the AAHK charges e.g. franchise fees, the level of which are already rather exorbitant. Making these fees too punitive would only serve to push up the costs to the airlines operating at HKIA; this would have the same effect as an increase in aeronautical charges.

Such concern is not without cause because the current charges at HKIA are already quite high. If we compare HKIA with other major airports in the region, which is more relevant than comparing with airports elsewhere in the world, the airport charges of HKIA are higher than Taipei, Seoul, Bangkok, Singapore, and Kuala Lumpur by 45%, 33%, 59%, 123% and 352% respectively. Obviously, any attempt to adjust charges at HKIA should be for reduction rather than increases.

As a result of severe competition and market demand for lower airfares and better quality of service, the yield (revenue per unit of activity) to the airlines has been declining over the past decade or more. During the past five years, the decline in yields to the IATA Member airlines on their international scheduled operations has been around 3.4% per annum. This need for reduced airfares is further demonstrated by the rapid growth of the "No frills" carriers.

Therefore, the airlines need to continuously improve efficiencies and reduce operating costs. In this effort, all providers of services to the industry also have to ensure that they in turn improve their efficiencies and quality of service while reducing charges to the airlines.⁸

⁸ IATA Submission to the EDLB of the Hong Kong SAR on the Need for Economic Regulation of the Hong Kong International Airport, 14 January 2004

Table 1 – Historical, January 2004

In USD	Charge 737-300						Charges 747-400					
	BKK	KUL	SIN	HKG	TPE	ICN	BKK	KUL	SIN	HKG	TPE	ICN
Total Per Flight	2,036	1,647	1,753	3028	1,668	2,496	5,179	4,450	5280	8,307	5847	7172
HKIA is Higher by %	49	84	73	0	82	21	60	87	57	0	42	16
Paid by Pax	1,487	1,485	1,488	1,811	1,138	1,813	3,320	3,315	3,321	4,041	2,551	4,046
HKG is Higher by %	18	29	18	0	20	0	22	22	22	0	58	0
Paid by Airline	549	162	265	1,218	530	684	1,859	1,135	1958	4,266	3,296	3,126
HKG is Higher by %	55	199	139	0	61	27	129	276	118	0	29	36
Landing Charge	154	140	265	639	385	448	1,165	1,113	1,958	3,312	2,890	2,693
HKG is Higher by %	315	358	141	0	66	43	184	198	69	0	15	23

The above-abbreviated report dealt with a summary of the Landing Charges. Enclosure 1 provides a graphical chart that compares charges in four separate groupings; Landing Charges, Charges Paid by Airlines, Charges Paid by Passengers and Total Charges per Flight. The airports chosen are the five other Asian regional airports of the previous report; Kuala Lumpur, Incheon, Singapore, Chinese Taipei and Bangkok. The pages have been drawn from the IATA Airport and ANS Charges Manual. The table shows that there is not one category where is HKIA competitive. This means that the constant public pronouncements of the need for charges to rise to have a successful IPO of AAHK, if enacted, can only damage HKIA's competitive position even further. It is why IATA says that if this IPO is only about raising money then we cannot see why industry should support such a short-term measure. Currently only Japan and China are more expensive than HKIA. IATA is currently negotiating with Narita for charges reductions and China is going to review charges as their traffic grows.

Enclosure 2 gives the background spreadsheet analysis of the detail of all the charges, taxes, fees and levies that were valid at that time. The spreadsheet supports the graphical presentation. Enclosure 3 has the relevant Airport and ANS Charges Manual pages for your reference. There are some differences in the inclusion of Noise Charges and the fact that we have had to estimate the date of the exchange rates chosen at the time because the original spreadsheet was built up over a month. Never the less, the orders of magnitude are the same as the original report to EDLB in January 2004. Using the total charges comparison at the time then the relative differences of Hong Kong International Airport is as listed in the Enclosure and shown in Table 1 above.

Since the January 2004 IATA report to EDLB, the increased cost of fuel and the spread and addition of new Government imposts have affected the airline industry even more. In response the airline industry has not stood still, it has continued to achieve non-fuel/tax cost efficiencies of 3% per annum. In addition, IATA is leading an aggressive drive to reduce costs even further by simplifying the business and eliminating paper cost from tickets and cargo waybills by 2007 and 2010 respectively. All IATA and the international airline industry is asking for is that our airport and air navigation service provider partners achieve the same level of efficiencies on an ongoing basis. Lowering costs will expand the size of the business creating a far healthier market for all. This is especially pertinent for aviation dependant cities and regions such as the Hong Kong SAR.

Reported Study Differences

Differences will occur if for example the load factors, aircraft variants, survey dates and the anchor currency are not exactly the same. But these are minor variations compared to the absence of a particular charge, tax, levy, fee or cost. Other than the TRL study, IATA is not aware of the methodologies of the other studies LegCo may have obtained. We can say that the EDLB/AAHK cost comparison of Singapore and Hong Kong airports using the B747-400 and the A320 aircraft as compared to the IATA study, has:

- Minor differences because of the timing of the studies and the exchange rates.
- A reasonable difference because IATA used a two-hour gate parking time whereas EDLB/AAHK uses four hours for the B747-400. (Airports that allow up to four hours gate parking, especially at peak periods, are not driving efficiencies and may cause an over investment in gates.)

- A slightly bigger difference because IATA has used the (then) regional predominate B737-400 at 64 tonnes whereas EDLB/AAHK have used the Hong Kong predominate A320 at 73 tonnes. And
- While both studies use the B747-400, the major difference is that the EDLB comparison in the January 2005 LegCo submission does not include the current HK\$120 Airport Departure Tax paid by the passenger.

One other reason that the HKIA “landing charges” are so high compared to others in the region is that the Government includes the Terminal Navigation Charges (TNC) in the landing charges. Either other Governments include the charges in a Single Till arrangement, do not levy such charges or they are billed directly by the Air Navigation provider to the airlines thereby listing the costs separately and complying with ICAO ideals of transparency and fee for service cost recovery. The TRL study does show the differences within their coloured bar charts but it is not evident when copied into black and white submissions. IATA, while believing they should be separated, has included TNC in all “Landing Charge” summaries to ensure the comparisons are equitable.

Passenger Based Charging

Passenger based charging, especially for the provision of monopoly services, creates many opinions not only in Hong Kong. It is often beset by both emotional and genuine economic arguments.

Arguments against include:

- It complicates cost structures if it creates a number of charges; and
- There is no long-term benefit to airlines because competition between airlines is all about net rather than listed or regulated airfares and the purported benefits are “washed-out” with airline competition and time.
- They affect the market in the same way as Government Taxes.

Arguments for include:

- It supports the user pays principle, especially in terminal charges where the passenger is directly using the product.
- It is based on a fee for service ideal.
- It supports ICAO principles of transparency.
- Airports and airlines share traffic risk and rewards.⁹

Passenger or Terminal Building Charges are common in Europe and in Australia and a number of governments and airports support such regimes. While passengers are regularly surveyed on their opinions of their airport experience, and HKIA is currently rated highest in the world in two separate surveys, they are not asked what they think of the cost of the service. Having a visible Ticket Charge allows the passenger to assess the value of the service provided.

In 2001, Canberra airport stated:

⁹ ICAO Document 9082/6 *Policies on Charges for Airports and Air Navigations Services*, para 15

*“...The move to a passenger based charge also served to align airport revenue with airline revenue. The risk of passenger number downturns is therefore shared with airlines thereby allowing an airline’s exposure to airport charges to become a variable factor.”*¹⁰

In 2003, the Transport Department when discussing Sydney airports move to an even more extensive scheme than envisaged for HKIA;

*“...SACL’s passenger-based charge provides access to airside services on reasonable terms and conditions that are more efficient than the previous tonnage based charging arrangements.”*¹¹

Ground Transportation Costs

There have been no comparisons of ground transportation costs in any of the recent Hong Kong studies. Yet they are normally paid directly by the majority of passengers or are included in many tourist travel packages. While passengers may share transport or be driven to an airport, such charges and journey times are most clear in the passengers mind. Therefore, they need to be an essential part of any competitive comparison associated with airport costs. The differences in average downtown to airport journey costs can be significant. Especially at a time when competition between airlines is forcing the airline fare component of a journey cost ever downwards. The comparison is a clear reminder of why Governments, airports and airlines need to take into account all the relevant costs, levies, fees, rents, charges and taxes over the long term and not just for a one term IPO benefit nor just for a three year return on the investment.

It is significant that AAHK has experienced a dramatic drop-off in the number sightseers and passengers’ “visiting relatives and friends” to the airport since the move to Chep Lap Kok. This has meant that virtually all persons (including shoppers and contributors to non-aeronautical income) are passengers and or airline related business and staff. It strengthens the IATA/BAR claim to a broadening of aeronautically related business to the regulated till. It also confirms that the time and cost of ground travel does affect the market.

It is presumed that ground transportation costs were taken into account when Lantau Island was selected for the new HKIA site. LegCo Members may wish to compare the different ground transportation costs for Singapore and Hong Kong under the following broad groups:

- Business and High Premium Tourists – Taxi and Limousine
- Business and Tourists – Airport Shuttle and Train (Hong Kong)
- Budget Tourists and Backpacker – Public Bus and Train (Singapore)

City/Airport	Taxi	Public Bus	Hotel/Shuttle Bus	Rail
Hong Kong	HK\$400	HK\$40	HK\$140	HK\$100
Singapore	HK\$85	HK\$9	HK\$33	HK\$9

¹⁰ Capital Airports Ltd (Canberra, Australia) *Submission to the Productivity Commission Nov 01*

¹¹ Department of Transport and Regional Services (Australia) *Submission to the National Competition Council, 15 Aug 03.*

Dispelling Myths about the Claimed Unimportance of Airport Fees and Charges

“...Airport Charges account for less than 4% of airlines operating costs¹²...” (and are therefore unimportant.)

This is a commonly held myth, based on using published ICAO or IATA global data on airport charges without any examination of the hidden costs. However, use of this data is misleading for several reasons. As listed above other regions heavily bias the global data. It is also biased by the US carriers, which benefit from very low airport charges at airports that are funded by Federal ticket taxes. Excluding U.S. carriers, airport charges are a higher portion of airline costs than the nominal 3-4%. For a hub air carrier operating out of a high cost airport, landing and other charges are a much higher portion of total costs than the global average. Hub carriers compete with other hubs for connecting traffic. A hub with higher airport charges make all connecting services more costly to provide than the competitor. The ‘landing fee charges’ account does not include all charges by airports. In addition to landing fees, airlines pay terminal charges; land rent, rent for space in terminals for offices, lounges, etc., and various other airport charges such as charges for telecommunications services.¹³

Why high airport charges paid by airlines do matter!

When considering new routes, or additional frequencies to a hub airport such as HKIA, airlines consider marginal costs and marginal revenues. That is, they estimate the additional revenue that mounting the extra flight will generate. They then calculate the additional costs incurred in operating that flight. These costs will include the cost of the aircraft, the crew, and all the operational costs, which of course include the charges they pay for landing, parking and other aeronautical costs.

If the additional revenue is greater than the additional cost, the extra flight will be mounted, unless there is a more profitable use for the aircraft and crew. An extra flight will have a beneficial effect on any airport that aspires to be a hub, because one extra flight produces a large number of connections to other flights and destinations. It is therefore in HKIA’s interest to make itself as attractive as possible to airlines contemplating adding services to, and or from, Hong Kong.

While airport charges levied on airlines may constitute a small proportion of an airline’s total cost, they can represent a very large percentage of the marginal cost of an additional flight, especially the short-haul services which are an essential element of a successful hub. If these charges are too high, an airline will wait until traffic grows sufficiently to cover their cost on top of all its other operating costs of a new service at that time.

Thus, high charges will lead airlines to delay the introduction of new services. In the meantime, the traffic, which would have been carried, and the additional income that could have been earned, will flow across other competing hubs. High charges thus have a

¹² EDLB, *Consultation Document on Partial Privatisation of the Airport Authority*, November 2004

¹³ InterVISTA. *The Case for a Regulatory Mechanism for Airport Charges at Hong Kong International Airport*. October 2003

disproportionate impact on the pace of development of an aspiring hub airport such as HKIA.

The Sensitivity of demand for Air Travel to Price

Elasticity of demand is the subject of many market studies and aviation is no exception. It is true to say that; demand elasticities have altered recently with the exposure of charges and pricing to the Internet and especially in aviation where the entry of low frills carriers has fundamentally altered the market. Most Governments, airports and the traveling public readily accept that low frills carriers with lower ticket prices stimulate and grow the total market where ever they operate. However, most Governments and airports have not grasped or accepted the reverse responsibility for the results of the increases in charges that will decrease the size of the market.¹⁴

The constant, unjustified talk by financial advisors of a necessary increase in charges for HKIA will affect the market, the viability of the airport as a hub and Kong Kong's economic future. Despite the possible self interest of financiers in the lead up to an IPO, it is the lack of denial or a public statement of position by the Government and AAHK that only fuels the expectation of an increase among potential investors and drives the industry further from an agreement. It is why IATA says that prices must restructured and come down. The industry cannot support privatisation if the IPO is just about a short term one off sale price.

Airline Fares

The biggest component of airline travel cost has hitherto been the airline fare component. This is still valid for long haul flights although some regional flights are being obtained for less than the ground transportation costs of getting to/from the airports. Airline fares have reduced significantly over the last 40 years and the world's international airlines continue to reduce non-fuel costs by 3% per annum. Airlines are extremely conscious of the marginal cost pricing of travel and practice cost disciplines on a daily basis. The most obvious examples have been the recent attempts for inclusion of fuel levies on tickets where airlines have only attempted to recover partial increases in fuel costs and only to the economic point that they estimate the market will withstand. Even then, in a number of markets the airlines have had to withdraw the fuel levies and absorb all of the increases in their own bottom line to look for even further efficiencies.

Competition between airlines keeps air ticket prices coming down. The balance between stimulating the market and maintaining a viable aviation centre and hub with an accompanying local industry with support facilities, training establishments, employment and a technological base is a responsibility of Government. In the Hong Kong SAR, EDLB has maintained such a balance in an exemplary manner.

Hong Kong – Singapore

The next part of the EDLB question was related to the cost comparison between HKIA and Singapore as submitted by EDLB on 31 January this year. Above are the minor differences because of the exchange rate and date variations, the slightly bigger difference of the medium weight aircraft choice and the relatively major difference because of the exclusion from the EDLB report of the HK\$120 Airport Departure Tax that is paid by the passenger on

¹⁴ IATA Economics Briefing – *The Sensitivity of Demand for Air Travel Price*, Geneva March 2005

the ticket. As outlined above, some have argued that such a Tax should not be included in an airport comparison because it is a government fiscal measure. However, whether a Government and/or an airport collects revenue through fees, charges, or taxes, they are all viewed by passengers, along with ground transportation, as a cost of their journey, all imposts will affect airport competitiveness.

If a private company was undertaking an analysis on where to locate a business or its Headquarters then the accountant would need to assess all airport related costs in the comparison. Any increase in a Government Tax, airport levy or airline fare directly affects the market through the elasticity of demand and for that all three parties, Government, the airport and the airlines, are equally responsible.

The problem that LegCo Members are seeking to address is the question of the IPO of HKIA, i.e. how to look at the total cost, possible winners and losers, as well as the long-term economic future of the economy of the SAR. If LegCo recommends or endorses a price increase for an IPO of AAHK then they must also share in that responsibility.

Such questions are also regularly raised in other countries and in particular, Singapore, the other Regional airport in EDLB's comparison. A recent speech by Mr Boon Swan Foo, Chairman of CHAMPS, a wholly owned subsidiary of the Civil Aviation Authority of Singapore on the subject, "Airports as National Economic Drivers" said that airports are economic entities in their own rights "they generate employment at airport and associated industries" but he also said "the biggest challenge was how to balance the public service role and to be a viable business in its own right".¹⁵

Given that aviation is one of the largest single industry employers in the SAR, LegCo must address the public service role and the economic performance of Hong Kong as well as recognizing the need for AAHK to remain as a viable business. Since the LegCo meeting, the Singapore Government has issued a renewal of their "Air Development Fund", it is the most recent outcome of its holistic approach to the airport positioning as an economic driver of the country's future. The aim is to attract new airlines, new routes to/from Singapore and to assist established customers to grow their existing business. Although the details of the three-year HK\$1.5bn support package is yet to be finalised the airlines have proposed a continuation and possible further reduction of the existing published landing and parking charges. A report of the Minister's Parliamentary statement is at Attachment I. The key background points to the Singapore Government Minister's statements are:

- The announcement comes as a result of the Singapore Government strategy of viewing Changi Airport, along with the Port, as the economic driver of the country. And that it is
- A wholly owned Government company that is run on strictly commercial lines on a Single Till basis.

Included below is an extract of the EDLB January 2005 comparison to which has been added the Airport Departure Tax to achieve a more relevant "New Total" of comparative airport costs and go part way to equalizing the IATA study. Please note that the ground transport costs are yet to be added.

¹⁵ Air Traffic Controllers Guild (India) Seminar, Siri Fort Auditorium II, New Delhi 1-2 Nov 04

Table 2 – EDLB Report January 2005

Airport Charges for a typical passenger aircraft movement	Changi				HKIA			
	B747-400		A320		B747-400		A320	
	(HK\$)	(% of total)	(HK\$)	(% of total)	(HK\$)	(% of total)	(HK\$)	(% of total)
Landing Charge	15,955	35%	2,507	18%	25,961	60%	5,612	43%
Parking Charge ⁽¹⁾	1,028	2%	-	0%	2,496	6%	1,248	10%
Aerobridge Charge	2,998	6%	773	5%	-	0%	-	0%
Terminal Charge paid by airlines ^{(2) (3)}	-	0%	-	0%	6,233	14%	2,530	19%
Total paid by airlines	19,981	43%	3,280	23%	34,690	80%	9,390	72%
Terminal Charge paid by passengers ^{(2) (4)}	19,042	41%	7,729	55%	-	0%	-	0%
Security Charge ^{(2) (5)}	7,617	16%	3,092	22%	8,943	20%	3,630	28%
Total received by airport operator	46,640	100%	14,101	100%	43,633	100%	13,020	100%

Notes:

⁽¹⁾ Assume 4 hour and 2 hour turnaround for B744 and A320 respectively⁽²⁾ Assume seat capacity 371 and 151 for B744 and A320 respectively (73% load factor)⁽³⁾ Terminal charge paid by airlines at HKIA is HK\$23 per passenger⁽⁴⁾ Terminal charge paid by passengers at Singapore Changi Airport is S\$15 per passenger⁽⁵⁾ Security charge at HKIA is HK\$33 and that at Singapore Changi Airport is S\$6 per passenger

Source: IATA Airport & Air Navigation Charges Manual, 28 Sept 2004 (exchange rate as of Nov 1, 2004)

Table 2 – EDLB Report (Corrected)

	Changi		HKIA	
	B747-400	A320	B747-400	A320
Charges Total (as above)	46,640	14,101	43,633	13,020
Airport Departure Tax	-	-	44,520	18,120
New Total	46,640	14,101	88,153	31,140

Perhaps the most surprising part of the above comparison is that the Government is collecting more per flight from the passengers than AAHK is collecting from the airlines and the passengers combined. This is without the other obvious Government revenue that it receives in the form of other taxes and excise.¹⁶

Current Charges Comparison

Enclosures 1, 2 and 3 are purely historical. They address LegCo's question of the IATA (Jan 04) and EDLB/AAHK (Jan 05) submission comparisons. Enclosures 4 and 5 address today's issues in the same manner using the updated data at Enclosure 6. In addition, IATA has

¹⁶ Exchange rates IATA (Jan04) and EDLB submissions (Jan 05) only minor differences:

Friday, December 12, 2003 - 1 Hong Kong Dollar = 0.22120 Singapore Dollar

Wednesday, January 12, 2005 1 Hong Kong Dollar = 0.21028 Singapore Dollar

changed the medium weight aircraft in the study to the A320 and used the same load factors as EDLB/AAHK to assist LegCo in its deliberations. You will note from Table 4 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 for 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. AAHK, EDLB and LegCo need to take a very long hard look at HKIA's financial projections as well its competitive position in the region and decide whether exposing the airport to unfettered shareholder dividend needs at the expense of other stakeholders is really the way to proceed.

Table 3 – Current Charges Comparison

In USD	Charge A320						Charges B747-400					
	BKK	KUL	SIN	HKG	TPE	ICN	BKK	KUL	SIN	HKG	TPE	ICN
Total Per Flight	1,935	1,456	1,574	3,339	1,631	2,373	5,200	4,361	5,184	9,561	5,817	7,150
HKG Higher by %	73	129	112	0	105	41	84	119	84	0	64	34
Paid by Passengers	1,309	1,307	1,310	2,157	1,006	1,595	3,225	3,220	3,226	5,315	2,481	3,930
HKG Higher by %	39	85	53	0	36	17	65	65	65	0	114	35
Paid by Airline	626	150	265	1,181	625	778	1,976	1,141	1,958	4,246	3,336	3,220
HKG Higher by %	47	165	118	0	49	21	115	272	117	0	27	32
Landing Charges	178	127	265	639	439	511	1,171	1,119	1,958	3,312	2,890	2,693
HKG Higher by %	258	402	141	0	45	25	183	196	69	0	15	23

Pricing

In addition to the need to restructure Charges, IATA/BAR are working towards a reduction of AAHK Charges and the Government passenger tax. This is the first full year back from the post SARS era when HKIA was down to 27m passengers. AAHK expects to exceed 40m passengers per annum in 2006. Traffic is now ahead of pre-SARS targets and both IATA and AAHK believe that growth will continue at between 5% and 6% for the next 10 years giving ever-increasing rates of return even with future long-term capital investment that will be required in the next five to 10 years. Now is the time to advance HKIA's position in the region, further stimulate traffic growth and reach a pricing agreement before an IPO. The year ended 31 March will see AAHK profit rise towards or above HK\$1bn indicating that a charges reduction of 10% is easily achievable.¹⁷ A three to five year pricing agreement with industry will insert an extra level of certainty into an IPO with a pricing, service, regulatory and charging regime in place *before* investors make a decision to participate in the airports Partial Privatisation.

Airport Charges Structures

¹⁷ AAHK CFO Dr Raymond Lai, Capital Markets Forum, Hong Kong 17 February 2005

IATA has submitted to EDLB that we would like to see a restructure of the Charges at HKIA along strict lines of transparency and the user pays principle. It includes:

- **Landing Charges (LC).** An immediate 10% reduction in LC but no change to the current tonnage basis.
- **Terminal Navigation Charges (TNC).** Separation from the Landing Charges and a commitment to transparency and efficiency. While the amount and methodology may be frozen for the initial three-year period it should be exposed to cost reduction mechanisms. While the TNC may continue to be collected by AAHK, it should be on a fee for service basis and not be part of the airport's charges. Desirably, DGCA would also recommend a 10% cut in TNC. However, as industry has no ability to examine or analyse the charges structure we can only rely on their public protestations as to the rationality and reasonableness of the TNC and their overall claims of efficiency.¹⁸
- **Security Charges (SC).** SC should be a responsibility of Government. If not then they should be calculated on a pass through, cost recovery methodology and charged on a per passenger basis. Cargo operations should continue on a per tonne basis.
- **Terminal Building Charges (TBC).** TBC costs should be on a per passenger basis and recovered from through the Ticket Tax system.
- **Airport Departure Tax (ADT).** No change in the ADT structure but the Tax should also be subject to efficiency measures and be included in any HKIA cost/market study comparisons. Given that the Government is now in a better financial position than in 2003, consideration should be given to returning the ADT to HK\$80 per departing passenger.
- **Parking Charges (PC).** No change in the PC at this stage but with a possible restructure of charges if HKIA experiences congested aprons. AAHK and industry would examine a cost benefit analysis balancing efficiency and new apron investment costs.

Conclusion

Previous airport and airline reports, in presenting their own studies to show the relativity of their respective positions, have created differing opinions that have led to confusion. LegCo members must necessarily take a much broader and comprehensive view of the existing cost relativities that is more akin to the passenger's reality. In addition, in the lead up to the Partial Privatisation of AAHK, LegCo Members must also bear in mind the threatened impact of the continual financiers' advice to the market that HKIA charges will need to increase to achieve a successful IPO when increasing returns each year demonstrates otherwise.

Reality suggests that it is the total of all airline and airport related charges and costs that affects the competitiveness of HKIA, its passengers and the economic future of the Hong Kong SAR economy. IATA believes that it is growth encouraged by competitive economics and efficiency encouraged by open, fee-for-service rational pricing that will ensure a long-term sound and reasonable return for the Government, the people and investors.

The airline industry is in open competition, vigorously driving costs from the business. We request that our partners recognise all imposts imposed on the market and similarly

¹⁸Hong Kong SAR DGCA to ICAO Planning Costing Symposium Bangkok January 2005.

undertake to drive efficiencies in their own businesses. This process can be started at HKIA by agreeing to an efficiency dividend for aeronautical and Terminal Navigation Charges and a restructuring and reduction of Charges of 10% and a reversion to a HK\$80 Departure Tax.

Attachment: In Parliament, Another S\$300m for Airlines at Changi dated 4 March 2005

Enclosures:

1. Charges Comparisons IATA Submission to EDLB, Jan 04, Graphical Presentation
2. Charges Comparisons IATA Submission to EDLB, Jan 04, Spreadsheet Analysis
3. Airport and ANS Charges as at Jan 04 (HKG, ICN, SIN, TPE, BKK, KUL)
4. Charges comparison IATA Submission to LegCo Apr 05, Graphical Presentation
5. Charges Comparisons IATA Submission to LegCo, Apr 05, Spreadsheet Analysis
6. Airport and ANS Charges as at Apr 05 (HKG, ICN, SIN, TPE, BKK, KUL)

IN PARLIAMENT

Another \$300m for airlines at Changi

The fund is meant to strengthen the airport's hub status and partnerships

By Alexandra Ho

THE Air Hub Development Fund, introduced in 2003, has proven so effective in attracting airlines to operate or expand their services here that the government will launch a new one next year when the existing fund expires at the end of the year.

The new \$300 million fund is meant to strengthen Changi Airport's hub status and its partnership with airlines, Transport Minister Yeo Cheow Tong said during the committee of supply debate in Parliament yesterday.

'About \$100 million will be set aside each year to fund traffic development and cost reduction initiatives,' he said. The fund will be disbursed over three years, though details are not available just yet. A Ministry of Transport spokesperson said more details would be out later this year.

Mr Yeo told Parliament that the existing \$210 million fund had facilitated airlines' growth and reduced their operating costs. This, in turn, resulted in a record 30.4 million passengers and 1.8 million tonnes of cargo handled last year. Changi's network has also expanded to more than 170 cities. Under the scheme, airlines enjoy a 15 per cent discount on landing fees at Changi and Seletar airports. Rental charges at both airports and Changi Airfreight centre are also slashed by 15 per cent, benefiting shops and other tenants. Other measures include incentives for airlines to expand their network out of Changi.

A Civil Aviation Authority of Singapore spokesperson told BT that to date, \$110 million of the fund has been given out. Asked about the impact of low-cost carriers (LCCs), Mr Yeo said traffic growth on key routes served by LCCs exceeded Changi's overall traffic growth. 'For the Singapore-Bangkok route, year-on-year traffic for the last quarter of last year grew 18 per cent,' said Mr Yeo.

Business Times - 04 Mar 2005

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**Giovanni Bisignani
Director General and CEO
International Air Transport Association (IATA)**

**Aerospace Forum Asia
Hong Kong
15 April 2005**

- Good afternoon and thank you for your kind invitation.
- Martin, you do a great job of bringing attention to our industry's many important issues.
- I only wish that we had more good news to talk about.
- We are a great industry.
- Air transport generates:
 - 4 million direct jobs US\$400 billion in output.
 - 24 million related jobs and US\$ 1.4 trillion in related output
 - or 4.5% of global GNP
- Air transport is the largest single sector employer in Hong Kong.
- We are a great generator of wealth:
 - GDP expanded three-fold in the last 30 years
 - But air transport grew seven times.
 - With 6% annual growth, this trend will continue.
- Our resilience is impressive:
 - In the last four years Asia-Pacific has rebounded from SARS, terrorism, war and now natural disasters.
- And our record on safety is tremendous.



- More people flew in 2004 than ever before—1.8 billion—and it was our safest year ever.
- Tragically there were 428 fatalities—the same level as in 1945 when only 9 million people travelled by air.
- This is a great achievement but we will do even better with programmes like IOSA—the IATA Operational Safety Audit.
- IOSA is the first global standard for airline safety management.
- Both Cathay Pacific and Dragonair are in the audit process.
- Already 28 airlines are on the IOSA registry and we will have 100 by the end of the year.
- IOSA is at the core of our efforts on safety that will lead to a further 25% reduction in the accident rate between 2004 and 2006.
- Our commitment to safety is strong, despite the dismal situation of our industry's finances.

Airlines lost US\$4.8 billion in 2004.

- This brings 2001-2004 losses to US\$36 billion.
- There are lots of reasons for the loss, but the extraordinary price of oil is at the top of the list.
- The industry fuel bill grew from US\$44 billion in 2003 to US\$63 billion in 2004.



- If oil averages US\$43 (barrel/Brent) for 2005, we can expect a fuel bill of US\$76 billion and a loss of US\$5.5 billion.
- We cannot continue like this.

The industry has lost its balance.

- Governments deregulated airlines, but did not look closely enough at the playing field or the rules.
- The rules of the game are outdated:
 - Despite being a global industry, airlines are restricted by tight ownership and control rules.
 - And the bilateral system restricts our ability to serve markets efficiently
- And too many of our costs are beyond our control:
 - 10% are in the hands of monopoly suppliers—airports and air navigation service providers.
 - In most cases there is no regulation to encourage the efficiency that a deregulated industry needs.
 - On top of that 20% of our costs are now in fuel—also beyond our control.
 - So a third of our costs cannot be attacked.
- Labour is the biggest cost item—between 18 and 38% of operating costs.
- Asia is fortunate to be at the lower end.
- But we all know how stubbornly difficult labour costs can be.



- Competition is intense
 - More aircraft are entering the industry.
 - Aircraft leasing further complicates the picture by giving greater mobility to our assets.
 - Low fare competition is now global
- And airlines continue to reduce costs and gain competitiveness.
- Non-fuel unit costs are dropping 2-3% each year.
- Consumers are happy because air travel has never been so cheap.
- More precisely, airline yields have never been as low.
- And what do governments do?
- Instead of modernising the rules of the game and putting pressure on our monopoly suppliers—they milk the industry for taxes and charges.
- They treat us as if we are as sinful as alcohol or tobacco.
- Mr. Chirac's proposal of an aviation fuel tax to save the world is the latest.
- We must remember that tourism is the backbone of many developing countries.
- Taxing the industry that facilitates global tourism simply does not make sense.

It is time to put the industry back in balance.

- We need to be as good at business as we are at safety.



- IATA represents 270 airlines and 94% of scheduled international air traffic.
- IATA's job is to lead the industry to solutions for safe, reliable and efficient air transport.
- Today I would like to highlight
 - The challenge to Simplify our Business and evolve to a low cost industry
 - The need for our partners to match airline efficiency efforts
 - And the urgency for governments to look at our industry in a different way.

The first of these is the airline agenda.

- Turning US\$40 billion in losses into profits will not be easy.
- Airlines are responding by re-engineering their businesses.
- Why?—because air transport is evolving to a low cost industry.
- Consumers value the great network that we have developed.
- But they get no value from the processes that make it possible.
- Many of these are paper-based, complex and expensive.
- We have to keep the value but cut the cost.
- IATA is leading a programme to Simplify the Business that will cut costs and enhance service.



- We are creating a revolution in the way people travel and ship with:
 - 100% e-ticketing by 2007
 - bar coded boarding passes
 - common use kiosks for check-in
 - radio frequency identification for baggage management.
 - paperless cargo
- The technology exists.
- Most airlines already have some of the benefits of this technology.
- IATA's job is to make these solutions available industry wide.
- We print over 300 million tickets and handle US\$225 billion in industry settlements.
- By itself e-ticketing will bring at least US\$3 billion per year in cost savings.
- The task is enormous.
- But saving billions while making travel more pleasant is worth the effort to change.
- I discussed Simplifying the Business with Minister Yang in Beijing on Wednesday.
- The CAAC and the Chinese carriers have agreed to be strategic partners with IATA in making China a model of the new way to travel.
- In this same spirit of cooperation we discussed the problem of air space management in the Pearl River Delta region.



- The inefficiency in the system costs airlines over US\$400 million per year.
- Fuel efficiency and environmental responsibility are at the top of our agenda.
- This unneeded cost is simply not acceptable.
- I am pleased to report that we agreed to intensify efforts to resolve this important issue for Hong Kong.

Similarly, our partners—airports and air navigation service providers—must match our efficiency efforts.

- US\$40 billion is the annual bill that airlines pay to our monopoly suppliers—airports and air navigation service providers (ANSPs).
- This is 10% of our operating costs.
- We pay when we fly, land and park.
- So it is important that we pay for value, not inefficiency.
- Governments fostered airline competition but gave us phantom regulators for monopoly suppliers.
- And now we are seeing the privatisation of these suppliers.
- Quite frankly, I do not care who owns the airport or air traffic control.
- It is the cost and the service levels that matter.
- You have a great airport.



- It won top honours in the IATA and ACI (Airports Council International) AETRA customer satisfaction survey.
- And it is a great catalyst for Hong Kong's economy.
- It is important that the privatisation continues benefits all parties:
 - The people of Hong Kong
 - The government
 - The airport customers—travellers, shippers and airlines.
- A successful IPO for an airport privatisation is not just an investor problem—we all need to be winners.
- I am pleased with the process of consultation.
- It has been extended to ensure a thorough examination of options.
- Now let's make sure that we make the right decisions.
- I am disturbed by the arguments that charges at the airport will need to rise.
- I believe that the IPO can realise the required HK\$30 billion with reduced charges.
- A cost competitive airport is critical for investors.
- Already Hong Kong has the highest charges to airlines in this region next to Japan and the mainland of China.
- Any increase in charges will disadvantage Hong Kong compared to its neighbouring airports.



- A successful privatisation should generate efficiencies to allow for reduced costs.
- We cannot accept a change in structure that results in higher costs.
- Higher costs would be bad for the airport's future.
- Lower aeronautical charges support increased hub traffic, which is currently 40% of Hong Kong's traffic.
- This, in turn, supports retail revenue streams.
- And it helps the competitiveness of Hong Kong.
- Don't risk the role of aviation in Hong Kong's economy by raising charges.
- Remember you have Macau vying for low cost traffic on the other side of the Delta.
- And only a short distance away is Guangzhou with its brand new and very impressive airport.
- Both are eager to get some of Hong Kong's traffic.
- As we consider privatisation, let's also remember that the airport is already profitable.
- It made a HK\$520 million profit in FY 2002-2003.
- This is impressive for a new facility during an economic downturn.
- FY 2003-2004 was dominated by the negative impact of SARS.
- But in 2004-2005 we expect a profit of HK\$1 billion or a 4% return.



- The potential for growth is tremendous—you are part of the fastest growing market in the world.
- We expect growth of between 5.3% and 5.7%
- The potential gain is enormous.
- And we have recent experience of what happens when the airport stops functioning—the entire economy stops, as we saw with SARS.
- So let's use the asset strategically to gain maximum benefit.
- As with any privatisation, our bottom line is simple:
 - Transparency
 - Efficiency
 - Benefits for all stakeholders and
 - A strong independent regulator
- We are more than happy to work with the Government and the airport to achieve these.

Finally, governments must show leadership and look at our industry in a different way.

- Specifically, they must address:
 - Security
 - Liberalisation.

I'll start with security.

- Three and a half years after September 11, security is tougher, but the system is still a mess.



- Global standards, harmonisation and international cooperation are the backbone of our great safety achievements.
- But security is being handled in a completely different and inefficient way.
- Airlines and their customers get the US\$ 5.6 billion bill for the resulting inefficiency.
- We need a different and more effective approach.
- Governments cannot continue to ask air travellers to pay for their own security when it is a state responsibility everywhere else.
- And we cannot continue with unilateral half-measures that ignore the need for global solutions.
- We need to use our resources efficiently to battle terrorism, not bureaucracy.
- **Finally, governments must give airlines the freedom to run their businesses like real businesses.**
- Deregulation without the freedom to do business is not a responsible policy—and it is killing the industry.
- Competition and markets should define the future of our industry.
- Governments must not be afraid to lead and facilitate this change.
- We lost a great opportunity when US-EU talks on an open aviation area failed last year.



- The US and Europe are mature markets with similar size and levels of development and technology.
- Contrast this to China where we see a plan and action.
- Open skies were declared for Hainan.
- Liberal bilateral agreements are being signed.
- And the industry is growing and generating profits.
- Governments must not be afraid of letting markets work and airlines do business!

And the time for half-measures is over.

- Some of you may be surprised by how liberal IATA's thinking is.
- Others may have noticed a new and bolder approach by IATA to industry issues.
- I am shouting, in a polite way, to ensure that governments and our partners address our most pressing issues.
- Why, because change is critical.
- We cannot live with half-measures and contradictions of the past.
 - Intensifying airline competition without effective regulation of monopoly suppliers.
 - Creating competition to lower fares while taxing beyond reason.
 - National rules for a global industry
 - Mis-regulation and micro-management in place of leadership.



- Today we have a new IATA that is tough and focused on delivering relevant results.
- Our members—network airlines—have done a great job.
- We are working hard to simplify our business and deliver the value that our customers and shareholders deserve.
- I hope that these same principles will guide Hong Kong's discussion of airport privatisation.