



"Richard Reed"

15/02/2005 14:04

To: <airportcomments@edlb.gov.hk>
cc:
Subject: Comments on AAHK privatisation
 Urgent Return Receipt

Please find attached



Dear Sir/ Madam

This is in response to your request for comments on the proposed partial privatisation of the Airport Authority.

Some preliminary comments:

A partial privatisation has the potential to be the worst of both worlds. Leaving the HK Government as the dominant shareholder means that any expected efficiency gains from moving to private sector ownership are unlikely to happen (or, happen just as well with full Govt ownership) However, the change in funding sources to include expensive private equity is likely to increase pressure on the AAHK to make possibly unwise decisions. If the government wants to raise money, while retaining control, there are better ways of doing it than via an equity IPO. Securitisation of future revenue flows for example, or privatisation of the non aeronautical side of the AAHK (i.e. split AAHK into an airport and a shopping mall, and privatise the shopping mall)

AA's Business Case and Valuation

XI) The taxpayers' 30.6 billion HKD investment must be regarded as a sunk cost. The question isn't what did we pay for the airport – the question is what is it now worth? If you compare the design, structure and build quality of HKIA with, say, Changi Terminal 1, or the new terminal at Detroit, it appears obvious to me that a significant amount of the 30.6 billion HKD went into positioning HKIA as a showcase for HK, rather than what was strictly necessary for a functioning airport. Soaring ceilings may be beautiful, but it is wrong to expect users to pay extra for what they did not need or specify.

If the airport had been built from the beginning as a commercial enterprise, there is no way it would have cost 36bn HKD. It wouldn't look so fantastic, like a modern cathedral, but it would have still had the same capacity (or more) and efficiency (or better). Unfortunately, I think that in any privatisation, the taxpayers' will need to bear the difference in ongoing value of the airport, versus what it cost to build. We must see the difference as the price of a building that we are all proud of, and is a monument to HK. In the same way that "users" will not be expected to pay the full cost of infrastructure for Beijing 2008, but Chinese taxpayers will pick up the difference

XII) Yes, I attach less importance to the valuation of the airport, more to keeping charges reasonable. One issue you do not raise is the 100 HKD airport tax, at present paid to the General Fund. If the Government feels the return on assets of the airport is too low, this should be given to the AAHK instead – and would also tie in well with making users pay.

XIII) Agree. However see my response to (XII) If "user pay" is the standard, the airport tax should become a user charge, paid to AAHK by passengers. The investment in the Airport cannot, in my opinion, have a reasonable and fair return, due to the fact the users were not given a choice in the first place about the luxuriousness of the AAHK. It is not now fair to turn to users and say to them – yes, we know that what you want is a transport solution, but you've been given a marvel of modern architecture and design, now pay the difference.

XIV) Single till versus double till. Agree in principle to double till – would love to see the details. Who bears the cost of A/C – the shops or the passengers?

XV) Agree to having separate rates of return for commercial/ non commercial business. I think you will find the CAA in UK has a lot of work you can build on for this. For what it is worth, they calculate the weighted cost of capital for airport operations to be 7-7.5%.

XVI) Agree. However, there will be need to be discussions about the ability, or desirability, for the AAHK to price discriminate. E.g. – should the AAHK be allowed to give lower charges for flights from countries that they want more visitors from? (i.e. Japanese who will spend more in

duty free versus backpackers from Australia). Can Cathay and CNAC negotiate volume discounts? Would prices go up at CNY? All the above (volume discounts, price discrimination for anchor tenants, price increases at peak periods) are common in *commercial* contracts – which is, you state, the basis on which negotiations will take place. If you do not allow this, then the privatisation of the airport will not lead to commercialisation, and the whole point seems to be lost.

- XVII) This shows the problem – if the airport is allowed to be commercial, there should be no problem reaching agreement. Either the airlines will act as monopsonists, and tell AAHK this is what they will pay and no more (which could well be zero, on the basis they can fly elsewhere) or the AAHK will be a monopolist and give the airlines a take it or leave it offer. If a statutory body is going to be required to form, and impose, a level of charges that is reasonable, given the operating efficiency of the airport, expected rate of return, inflation, etc. then the market won't be working, and theoretically we are exactly where we are now, but some investment banks and consultants will be very happy.
- XVIII) Good idea, but no reason why this can't be done now. An IPO is not necessary
- XIX) Disagree. If the AAHK is privatised, any undeveloped land should be returned to Govt beforehand. The AAHK can then make representations to the government if land is required for AAHK purposes. Other parties can make bids or representations for other uses. For example, if another hotel is required, (or a catering facility, or cargo warehouse) there is no reason why the Government should not lease the land direct for this purpose, rather than the AAHK lease the land.
- XX) If the government remains the majority shareholder, this seems pointless – as the main shareholder, the govt can approve/ disapprove any such ventures via its control of the board.
- XXI) Agree

Overall – I am in favour of privatisation. But I would split the airport into two, and privatise/ securitise/ lease out the non aeronautical part. With your double till proposal this is effectively what you will need to do anyway (separate the two functions)

The HK public needs to face the truth that CLK is a great airport, but much of the sunk cost is lost. It was a price worth paying (looking back to 1989-1990, the value of confidence boost of deciding to build such a world class airport in HK, rather than the more rational, far cheaper location of Shenzhen, was uncalculable)

To push up charges to cover the perceived sunk costs is an economic folly, and will lead to misallocation (basically, fewer flights to HK than should otherwise be)

Yours truly,

Richard Reed