

**For discussion
On 31 January 2005**

Legislative Council Panel on Economic Services

Response to Questions raised on 22 November 2004 Relating to Partial Privatization of the Airport Authority

Introduction

The Administration issued a Consultation Document on Partial Privatization of the Airport Authority (AA) on 22 November 2004 to further consult the public widely on the regulatory and institutional issues pertinent to the proposed privatization of AA.

2. Before the public consultation commenced, the Administration sought Members' views on the Consultation Document at the Panel meeting held on 22 November 2004 (LC Paper No. CB(1)230/04-05(03)). Members raised a number of questions and requested the Administration to provide responses for further discussion at a special meeting scheduled for 31 January 2005. In addition to the information supplied to the Members at previous meetings of the Panel held on 23 February 2004 and 2 March 2004¹ respectively, this paper provides further information on issues relating to labour, justifications for privatization, monitoring and financial position of the Hong Kong International Airport (HKIA) and airport charges.

Specific Questions

A. Labour Issues

- (i) How could the privatized AA help ensure that the benefits of those staff working under the airport franchisees and contractors would not be affected?*
- (ii) Any concrete measures that could help safeguard the benefits and well being of staff working on the airport island so as to relieve the concerns of the staff?*

¹ LC Paper No. CB(1)1017/03-04(05); LC Paper No. CB(1)1154/03-04(01); and LC Paper No. CB(1)1749/03-04(01).

(iii) AA should address the issue of public safety when contracting out airport services.

3. Although the employment conditions of staff working for AA's franchisees and contractors are determined by the companies concerned, AA always encourages these companies to remunerate their staff according to the prevailing market conditions. It also adopts specific measures to help ensure that this will be done.

4. It is AA's established policy to select service contractors taking into account their experience and service quality instead of price alone. This is clearly stated in AA's invitations for tenders, so that bidders fully understand the importance of maintaining a quality workforce. Bidders are required to make separate submissions of technical and financial specifications for independent assessment. Those who fail in their technical submissions will not be selected, regardless of their financial bids.

5. Furthermore, drawing reference from the Government's practice, AA recommends to its contractors that the average monthly wages for their non-skilled workers should be in line with the relevant market rates as published in the latest Census and Statistics Department's Quarterly Report of Wage and Payroll Statistics at the time when tenders for contract are invited. AA also requires its contractors to provide documentary evidence to prove that they pay their employees according to their contracts to ensure that its contractors do not seek to maximize their profits at the expense of their staff after the contracts are awarded.

6. AA has undertaken to continue with these specific measures for safeguarding the benefits and well being of the staff of its contractors after privatization.

7. As regards its own staff, AA employs less than 1,000 employees, representing only 2% of workers on the airport island. AA assesses and determines its human resources requirement based on business needs. Privatization will not bring about a need for a change in manpower requirement or terms of employment.

8. Looking ahead, AA foresees that the airport will provide even more job opportunities after its privatization. As a result of increased economic activities, some 6,000 direct and indirect jobs were generated in the past two years. Based on estimates of external consultants, AA expects that a further 19,000 direct and indirect jobs would be created in the next five years. With a

strong demand for additional manpower at the airport, the labour market for airport workers in the coming years should have a reasonably positive outlook.

9. AA also attaches great importance to safety at the airport, including that of employees working for its franchisees and contractors. Safety is a key element in AA's assessment of the performance of its service providers. AA regularly collects statistics on work-related injuries from these companies in order to monitor their safety records. In case of any safety concern, AA will require its franchisees and contractors to take remedial actions including enhancement of staff training or improvement of operational procedures as appropriate. AA will continue to uphold its efforts in this regard after privatization. In fact, after AA has become a listed company, the safety record of the airport will also be closely scrutinized by its shareholders and potential investors.

10. In addition, the Civil Aviation Department (CAD) will continue to monitor the safety aspects of airport operations through the Aerodrome Licensing process. CAD will require AA to maintain the current high safety standards regardless of whether AA is privatized or not. Safety will remain the Government's highest priority for the airport.

B. Justifications for Privatization

- (iv) *The Administration should provide information that sets out clearly the justifications for privatizing AA, including the recommendations of the consultant.*
- (v) *The Administration should provide more information, including an objective analysis of the pros and cons of the proposed privatization of AA prepared by financial advisor?*
- (vi) *Can the report prepared by the Government's financial advisor be released to the Panel for information?*

11. In pursuing privatization of AA, the Government's key objectives are to –

- (a) strengthen market discipline in the running of the airport for greater efficiency and more commercial opportunities;
- (b) enhance AA's access to the capital market;

- (c) introduce an additional quality stock to add diversity to the local financial markets;
- (d) offer an opportunity for Hong Kong people to participate in the success of a well-managed company with strong growth potential; and
- (e) proceeds from privatization will help strengthen Government finance in the short to medium term.

12. We consider that the main benefit of the proposed privatization would be to subject the management of the airport to stronger market and commercial discipline, so that the airport would be managed with greater efficiency and commercial opportunities more fully exploited. Although AA is already a statutory corporation operating on prudent commercial principles, its listing on the Hong Kong Stock Exchange would subject the new Company (i.e. the privatized AA) to a greater degree of scrutiny by other investors, which would help derive even more efficiency.

13. Turning the airport operator from a statutory corporation into a listed company would instill additional motivation and a more enterprising culture within the new Company. This would make our airport better positioned to respond to the rapidly changing aviation market in order to maintain Hong Kong's position as a centre of international and regional aviation.

14. While AA is currently able to borrow effectively from the debt markets, particularly in the light of the prevailing low interest environment, it is possible that AA would need to raise additional equity capital in future to finance the costly additional infrastructure required to fully realize the ultimate design capacity of the airport. A stock market listing provides access to such capital. Therefore, privatization via initial public offering (IPO) would provide the new Company with added flexibility to ensure that it would have access to the necessary funds for financing capital projects essential for expanding the airport capacity and maintaining Hong Kong's aviation hub status.

15. HKIA is one of the best managed airports in the world with good growth potential. When the new Company is listed, it would add a good quality local stock to our security market and provide international investors with an additional choice, thus further enhancing the attraction of Hong Kong's financial markets. At the same time, the listing of the new Company would provide an opportunity for Hong Kong people to share the success of this

thriving business. On top of offering an additional investment option for the public, this would also help enhance their sense of ownership of this prime infrastructure of Hong Kong.

16. Although not the foremost objective of the exercise, the privatization of AA would bring capital revenue to the Government in the medium term.

17. The Government's financial advisor has been asked to evaluate the case for privatizing AA. They have advised that privatization of airports is a key and growing trend in Europe, Australasia, China as well as other parts of the world. Privatizing AA would provide a clear and determined signal of the Government's desire to reduce its participation in a market economy. They have further advised that although AA already delivers high commercial and operating standards, there are tangible benefits in privatizing it for the following reasons-

- The market provides a level of scrutiny and a prompt, transparent reward-penalty system that cannot be replicated and hence encourages continuous improvement and innovation.
- Privatization will better position AA to fully leverage its airport management skills to develop commercial opportunities in the mainland and elsewhere.
- AA's performance-oriented culture will be better sustained as a private enterprise.
- Continued development of AA's business will create more varied job opportunities, providing AA's staff with better career prospects and job satisfaction.

18. A copy of the consultant's detailed advice (English version only) is at Annex A.

Annex A

19. In taking forward the privatization exercise, we are mindful that HKIA is a strategic asset of Hong Kong and that its smooth and efficient operation has an important bearing on our economy. Therefore, one of our key considerations is to ensure that Hong Kong's position as a centre of international and regional aviation is maintained. In particular, we have to ensure that the new Company will not pursue short term interests for its shareholders at the expense of the overall interests of Hong Kong. For this

reason, we have proposed a series of regulatory measures for the new Company, as detailed in the Consultation Document.

C. Monitoring

(vii) How would Government balance the policy initiative to promote aviation development in Hong Kong and alleged favouritism on the part of the Government to assist a listed company?

20. It is the Government's objective to promote the further development of Hong Kong as a centre of international and regional aviation. The key to our success is to attract more airlines and passengers to use our airport and the Government will continue to work closely with the new Company and other parties concerned in promoting Hong Kong as an aviation hub. Although the Government's efforts in this regard would also help improve the business of the new Company, there is no question of favouritism because it is clear that such a development would be in the overall interest of Hong Kong rather than benefit just a particular company. Furthermore, as competitors of HKIA are airports in the region rather than other businesses in Hong Kong, any initiative of the Government to promote HKIA would not be at the expense of other companies in Hong Kong.

(viii) How will the Government address the concern about conflicting interest between shareholders and the general public at large?

21. Within the future legislative framework for regulating the new company, we intend to provide expressly that the operation and development of HKIA will always remain the core business of the new Company. So the new Company's primary business objective must be to maintain the HKIA as a premier airport patronized by as many passengers, shippers and airlines as possible. There are therefore strong commercial incentives for it to maintain a safe and efficient airport with high service standards, provide a wide range of facilities and amenities for the convenience of passengers and attract more air traffic. In this regard, the interests of the shareholders of the new Company and the general public are totally aligned.

22. We are however mindful of the need to put in place appropriate mechanisms to ensure that a good balance can be struck between the shareholders' interest and the wider public interest whenever a conflict arises. Hence, we have proposed a package of measures in the Consultation Document, such as a more objective and transparent charge regulatory framework for the determination of airport charges, power for the Government to appoint

additional board members to represent the Government or public interests, and power for the Government to obtain information from the new Company.

23. Ultimately, the Government can also give directions to the new Company in the public interest. But considering the need to also safeguard shareholders' interest, we have also proposed that the Government may need to pay compensation to the new Company under specified circumstances, e.g. when it is directed to act contrary to prudent commercial principles, thereby suffering financial loss through no fault of its own.

24. When AA is privatized through an IPO, the prospectus will disclose details of the regulatory environment within which AA operates, including the Government's powers as outlined above, so as to ensure that prospective investors have a clear picture of the new Company before they invest.

(ix) Would the Government provide the necessary financial support to the privatized AA in case it suffers financial loss due to investment plan in the Mainland?

25. The new Company is expected to act prudently in conducting its business. Before making any investment, it would have to assess the risk involved having regard to its own financial strength. We have no plan to provide financial support to the new Company purely to make up for any investment losses. But so long as the Government remains the majority shareholder of the new Company, the Government will honour any financial duty to the Company in this capacity.

(x) The Administration should provide information on views collected during the early stage of consultation and the proposed regulatory framework.

26. When we sounded out stakeholders in early 2004, they were generally supportive of the objectives of privatization, but many cautioned that the Government has to carefully evaluate all the relevant issues and to ensure that public interests are safeguarded after the airport is privatized. Airlines also did not object to privatization in principle but were concerned about a possible increase in airport charges. More specific concerns of the stakeholders as well as how we intend to deal with them are set out below –

- (a) Regulation of airport charges – while some of those who advocate a free market favour allowing the new Company full autonomy in setting airport charges, the majority suggest that there should be a defined mechanism to govern the adjustment of airport charges to

prevent AA from unduly exercising its pricing power and extracting undue benefits from its users. Airlines are concerned whether there will be a guaranteed return for AA and a set of regulated activities, as these parameters would determine the level of airport charges. They also want to be consulted by AA before adjustment of airport charges is made and be given an avenue of appeal to either the Government or an independent body if necessary. We are proposing a form of transparent and objective regulatory mechanism that aims to address these concerns and at the same time provide sufficient commercial flexibility to the privatized AA for further consultation. We attach at Annex B for Members' reference a possible framework drawn up by our financial adviser. The details of such a mechanism are still being discussed with AA and the airlines. We are making good progress but no decision has yet been made.

- (b) Service standards and efficiency – the public attach great importance to maintaining high service standards and efficiency at the airport. We are proposing a penalty and reward scheme to help monitor the performance of the airport in these aspects.
- (c) Scope of AA's business and competition – given the privatized AA's monopolistic status, some people are concerned about its unparalleled advantages in certain business activities and the risk of it engaging in anti-competitive practices. We are proposing to allow flexibility for AA to conduct all airport-related activities, but at the same time introduce statutory prohibitions against anti-competitive activities and abuse of dominant position by AA to address potential public concerns.
- (d) Land use control – considering the vast amount of land under AA's control, some people are concerned about the risk of AA engaging in property development and creating unfair competition in the property sector. The existing land grant to AA contains stringent controls over land use on the airport island and only airport operational, airport support, and airport related developments are permitted. AA is not allowed under the land grant to develop residential properties. We consider that these stringent controls should have provided sufficient safeguards against any abuses and we propose to allow AA to continue to hold and make use of the land on the airport island subject to existing planning controls and land grant restrictions.

(e) Residual Government controls – the majority of stakeholders consider the airport a strategic facility and emphasize the need for Government to retain suitable controls over AA after privatization. On the other hand, we have to allow suitable commercial flexibility for the privatized AA to operate as a listed company. The package of proposals contained in the Consultation Document aims to strike a balance between the competing considerations.

(xi) *Please provide a comparison between HKIA and other overseas airports and the impact of HKIA upon AA's privatization in terms of being an aviation centre in the region.*

27. In studying the privatization of AA, we have made reference to other airport privatization experiences. A comparison between HKIA and these airports in terms of their throughput and aviation network is at Annex C. We also attach at Annex D a table showing the change in passenger and cargo throughput of these airports around their privatization. It can be seen that after privatization, all these airports concerned continued to thrive. We are confident that with the additional flexibility and enterprising culture of a listed company, the privatized AA will also be well-poised to further develop Hong Kong's position of a centre of international and regional aviation.

Annex C

Annex D

D. Financial position of HKIA and airport charges

(xii) *The Administration should provide further information on airport charges and the past financial results of AA.*

(xiii) *What are the contributions from airport charges and other commercial activities?*

28. At HKIA, airport charges comprise three elements, namely landing charge, parking charge and terminal building charge. The scale of these charges is set out at Annex E.

Annex E

29. Revenue from airport charges accounts for around 40% to 45% of AA's total income since airport opening. The table below shows the amount of airport charges revenue and the financial performance of AA since the opening of the airport.

AA - Summary Performance

(HK\$ million)	98/99 ⁽¹⁾	99/00	00/01	01/02	02/03	03/04 ⁽²⁾	98/99-02/03 CAGR ⁽³⁾
Revenue from airport charges	1,716	2,310	2,272	2,325	2,446	2,170	1.7%
Other revenue	2,057	2,745	2,887	2,949	2,971	2,869	2.0%
Cash opex ⁽⁴⁾	2,282	3,057	2,801	2,772	2,752	2,692	-2.5%
Cash margin	1,491	1,998	2,358	2,502	2,665	2,347	7.6%
Profit before tax	(384)	(163)	77	243	631	488	
Net profit / (loss)	(388)	(168)	71	236	502	386	
Total PAX (M) ⁽⁵⁾	22	31	34	33	34	28	4.2%
Cargo (000 tons)	1,199	2,061	2,230	2,121	2,546	2,737	12.3%

Note: (1) 9-month results only.

(2) Financial year 03/04 performance affected by SARS.

(3) Compound annual growth rate.

(4) Cash operating expenditure.

(5) Passenger (Million).

30. During the above period, AA has striven to grow revenue and control expenditure. Through productivity enhancement, AA was able to achieve a 2.5% p.a. reduction in cash operating expenditure amid increasing traffic. AA has also continued to develop new revenue sources. For example, AA expects that its retail revenue would increase by around 15% in year 2004/05 as a result of the completion of the Passenger Terminal East Hall expansion.

(xiv) Why is the information provided by the Government regarding airport charges of HKIA different from that provided by Hon Howard YOUNG?

(xv) What is the Administration's view on the competitiveness of HKIA under the current level of airport charges?

31. The components of airport charges vary greatly among different airports. When comparing the level of airport charges at two airports, it would be necessary to examine all the charge components rather than just look at merely landing or parking charges. For illustration, we set out below two examples showing the airport charges at Singapore's Changi Airport and the Hong Kong International Airport (HKIA) for two typical aircraft movements.

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

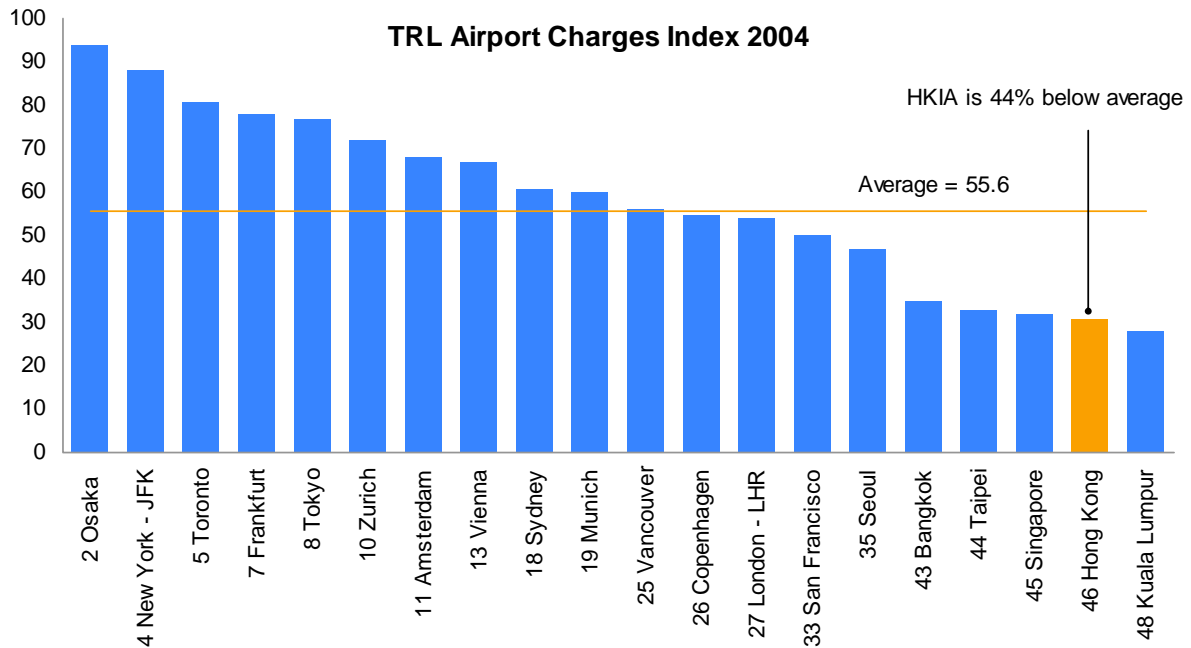
⁽⁵⁾ Security charge at HKIA is HK\$33 and that at Singapore Changi Airport is S\$6 per passenger

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

32. In the information provided by Hon Howard Young, the comparison focused on the charges paid by airlines and omitted charges levied by the Changi Airport on passengers. Although airlines collect the terminal passenger charge on Changi's behalf, such passenger charge does not affect their financial results. On this basis, the total charges to airlines at Changi are lower than those in HKIA. However, AA considers that the level of total airport charges levied by the airport operator is a more appropriate measure of the overall competitive position of an airport. Otherwise, any airport could easily claim to have increased its competitiveness simply by changing its charge structure by levying all or most of its airport charges from passengers instead of from airlines.

33. In conducting its annual Review of Airport Charges, UK-based independent aviation consultant TRL also benchmarks the total airport charges levied by airport operators, i.e. in line with AA's approach. In TRL's 2004 review, the level of airport charges at HKIA was found to be 46th among the 50 major international airports surveyed. The results are summarized in the chart² below.

² The survey did not cover airports in the Mainland of China. If computed on the same basis, airport charges for international flights at Mainland airports are about double those at HKIA.



34. Considering the result of the above independent survey and the high quality services offered at HKIA as testified by the international acclaims it has obtained, the Administration shares AA's view that the existing level of airport charges at HKIA is very competitive among other major airports in the region. However, in view of the rapidly changing aviation environment and the keen competition in the region, we do not want to see airport charges increase unreasonably. In fact, we support any initiative by AA to further enhance its competitiveness, e.g. the recent reintroduction of the 2-year new destination incentive scheme whereby airlines will receive 50% discount on landing charge for the first year and 25% discount in the second year of their new services.

(xvi) What are the proposed level of increase in airport charges and the target rate of return of the privatized AA?

(xvii) If AA is not allowed to increase airport charges, would the valuable asset of the general public be sold at a price which is far below its real value?

(xviii) Airlines are of the view that in the case of AA, a 2% return on investment is not unreasonable, particularly when compared with Osaka Airport the return rate of which is only 1%.

(xix) Regarding the rate of return on investment, do AA and other overseas airports adopt a similar basis for calculation, for example, whether the investment and operating costs of runways are included?

- (xx) *Some airlines suggested that AA should adopt a so-called “single-till” approach where the profits from both aeronautical and commercial activities should be taken together in calculation of the target return, so that the profits from the privatized AA’s commercial activities could contribute towards keeping airport charges more competitive.*
- (xxi) *How would the Administration strike a balance between increasing AA’s rate of return on investment after privatization and lowering airport charges to increase the competitiveness of HKIA?*

35. The return of a company is a measure of its profitability relative to the assets employed in its business. When computing a company’s return, it is necessary to take into account all the revenue generated by its assets as well as the associated costs. AA’s asset base includes, among others, HKIA’s runways and taxiways, the terminal buildings and other fixed assets. From this asset base, AA generates aeronautical and non-aeronautical revenues. There are costs associated with operating the AA’s activities (for example, staff and energy costs) as well as with asset ownership (such as depreciation on AA’s asset base), and these need to be reflected when AA’s return is calculated. AA’s accounts are prepared and audited in accordance with all applicable Statements of Standard Accounting Practice and Interpretations issued by the Hong Kong Society of Accountants.

36. Different companies and jurisdictions may adopt different accounting standards and depreciation policies, which may give rise to variations in the computation of, say, depreciation charges for other airports. But the principles with respect to the computation of returns are broadly similar.

37. We have carefully considered the suggestion of adopting a “single-till” approach. Under such an approach, the new Company sets its target rate of return on its entire asset base including aeronautical and non-aeronautical assets, at a level commensurate with the risk profile of the entire company. The company’s profit or loss from its commercial ventures would directly impact on the level of airport charges. The Government’s current proposal is to split AA’s asset base into aeronautical and non-aeronautical parts. Airport charges would then be determined based on a rate of return lower than the full commercial rate for the new Company to reflect the relatively lower risk profile of this part of the new Company’s business. This is the Government’s preferred option because it would incentivize the new Company to explore commercial opportunities; encourage it to make timely investments in aeronautical assets and maintain aeronautical

services at high standards; and isolate the aeronautical operations from the ups and downs of the new Company's commercial ventures.

38. While the "single-till" approach was adopted back in 1987 by the first listed airport body, the British Airport Authority (BAA), other airport privatizations have progressed since the IPO of BAA. In fact, a number of recently privatized airports in Continental Europe, Australia and New Zealand have adopted a regulatory arrangement closer to a "dual-till" approach, which promotes economic efficiency, leading to better utilization of airport capacity and enhanced incentives to deliver timely investments in aeronautical facilities.

39. The Administration has not come to a view on the exact level of airport charges or target return of the new Company after privatization. In fact they are not dictated solely by the Government. If AA is unable to improve its return over time to a level commensurate with the perceived risk of its business, investors would only pay a price at a discount to the equity value already invested in the business, thereby making it impossible for the Government to recoup taxpayers' investment in AA.

40. As we have pointed out in the Consultation Document, the question is whether the costs of constructing and running the airport should be fully recovered from its users in the long term. It is a choice between securing a better valuation at IPO by increasing airport charges in the next few years, or keeping airport charges more competitive at the risk of undermining the valuation at IPO, thereby diminishing taxpayers' investment in AA. This is a difficult choice we have to make and we are seeking the community's views on the matter before deciding on the way forward.

41. AA and the airlines are currently discussing the details of the mechanism for determining airport charges. Whether there is a need to increase airport charges or how it should be increased would depend on the outcome of their discussions, as well as any change in forecast growth in air traffic at HKIA prior to IPO.

(xxii) To increase AA's rate of return on investment, does AA have plans to increase the flow of people and goods through HKIA and measures to cut cost and improve efficiency? Is there a need to review the salary structure of AA staff with a view to lowering cost?

42. The success of an airport in attracting more people and goods depends on three important factors, namely, air services network, catchment areas and the facilities of the airport itself. With the support of the Government, AA has been taking active measures to enhance all three.

43. After decades of effort, Hong Kong has established an extensive network of reliable air services. Under the framework of over 50 bilateral air services agreements, Hong Kong is now connected to 140 cities by 4,500 weekly services operated by over 70 international airlines. This extensive network represents a good mix between international services and services to the Mainland of China, and between long-haul and shorter haul regional services. Such a network also creates a highly competitive environment for airlines to offer quality services at reasonable prices to passengers and shippers. The Government is firmly committed to further expanding our air services network progressively.

44. We are also taking a multi-pronged approach to expand HKIA's catchment areas. Cross-boundary high-speed ferry services have been introduced since September 2003 between Chek Lap Kok and PRD cities. At present, these ferries are serving six destinations and carrying close to 3,000 passengers every day. AA is working to further improve such ferry services by providing advanced check-in counters at some PRD cities. AA has also helped promote and facilitate the operation of cross-boundary coaches at the HKIA. These coaches now carry over 3,000 passengers daily on average between the airport and 40 cities and towns in PRD. To further attract Mainland passengers to use HKIA, AA has spearheaded the "Fly via Hong Kong" programme to provide a more efficient ticketing platform in the PRD to facilitate booking of flights out of Hong Kong by PRD residents. On the cargo front, the efficiency of customs clearance at the boundary control points has greatly increased in recent years, thus reducing the time and cost for Mainland shippers to use HKIA for their air freight.

45. At the same time, AA has been expanding the facilities at HKIA, both to enhance its attractiveness to transfer passengers and to cater for increasing traffic. The recently completed East Hall expansion has provided more space and shopping attractions for passengers and the new SkyPlaza to be completed in 2006 will provide additional passenger processing facilities and amenities. The Asia World-Expo and the Disneyland will be opened in the coming year and they will help attract more people to use the HKIA. AA is also expanding its cargo facilities to cater for the increasing demand. These include additional cargo aircraft stands, a new cargo terminal by the Asia Airfreight Terminal Limited and new express cargo handling facilities.

46. On cost control and efficiency drive, AA was able to achieve a 2.5% p.a. reduction in cash operating expenditure notwithstanding a 4.2% p.a. increase in passengers and 12.3% p.a. increase in cargo since airport opening. Meanwhile, AA continues to increase its commercial revenue. With the

completion of the East Hall expansion, AA expects that its retail revenue would increase by around 15% in 2004/05. Based on the recently published TRL Airport Performance Indicators 2004, the average commercial revenue per passenger at HKIA is among the highest in the world. It ranked the 4th after Narita, Heathrow and Osaka and above Gatwick and Singapore, and was 76% above the world average.

47. As regards staff costs, AA has maintained a lean organizational structure. Staff costs account for only 20% of its operating expenses. Furthermore, AA engages human resources consultants to conduct regular surveys to benchmark the salaries of its staff against other companies in Hong Kong to ensure that its remuneration package is not out of line with comparable organizations. AA will continue this practice in future.

(xxiii) What are the projected price to earning ratio of AA upon listing and the possibility of achieving the target?

48. Generally speaking, the price to earning ratio of AA upon listing is subject to a number of factors, some of which are outside the control of Government and AA, such as the prevailing stock market conditions. It is possible that AA could be listed at a similar level to the market if AA displays growth and yield characteristics that are in line with other market constituents at the time. However, if it is expected that AA's growth or yield will materially exceed or underperform the market, then investors would likely accept a ratio for AA that departs from the market average. In addition, investors may also benchmark AA against other airport operators rather than the local Hong Kong market and use other valuation criteria (such as EV/EBITDA³ and Discounted Cash Flows), and may thus have a different valuation perspective on AA as a result.

49. Since the average price to earning ratio of a market changes with the prevailing market and global sentiments from time to time, and the market's perception of AA's business outlook may also change, a more meaningful estimate could only be made nearer the actual IPO.

Economic Development and Labour Bureau
24 January 2005

³ EV/EBITDA is the ratio of enterprise value to earnings before interest, tax, depreciation and amortization.

Monetisation paper



Disclaimer

UBS AG ("UBS") was engaged by the Government of the Hong Kong Special Administrative Region ("HKSARG" or the "Government") to provide independent advice on the feasibility of partial privatization of Airport Authority Hong Kong ("AA"). Our financial advice, under the terms of our engagement contract, was contained in various reports to HKSARG (the "Reports"). The information and analyses contained in, and opinions expressed in, the Reports were based, among other things, upon confidential information provided to UBS by Government and AA.

This document is an abridged version of the Reports produced at the request of the Government. Given that the analysis underlying some elements of the report has been based on sensitive information, sections containing or referring to such sensitive information have been omitted from this abridged version. Accordingly, this document does not purport to or necessarily contain all the information that may be necessary to fully evaluate the feasibility of a partial privatisation.

No representation or warranty, expressed or implied, is or will be made in relation to the accuracy, fairness, reasonableness or completeness of any information contained in this document or that any information remains unchanged in any respect. No responsibility or liability is or will be accepted by UBS or by any of its officers, employees, advisors and agents in relation thereto and accordingly none of them shall be liable for any cost, loss or damage incurred or suffered by any recipient or any other person in connection with or arising out of the use of this document or any reliance placed thereon. Information included in this document is based on the conditions prevailing at the time of the partial privatisation study and may be subject to change or amendment to reflect changing circumstances.

Table of contents

SECTION 1	Introduction	3
SECTION 2	The importance of capital structure	7
SECTION 3	Methods of reducing Government equity ownership	9
3.A	IPO	11
3.B	Sale of a minority stake to a strategic investor	15
APPENDIX A	Selected international precedents	18

SECTION 1

Introduction

Introduction

The Government has articulated five key objectives for the potential partial privatisation of AA. These are: (i) reaffirming the Government’s commitment to a free market economy, thereby reducing the role of the public sector; (ii) optimising the utilisation of scarce public resources; (iii) introducing private ownership to further strengthen commercial focus at AA and broaden access to AA’s sources of capital; (iv) enhancing the diversity and depth of the Hong Kong equity market; and (v) providing the Hong Kong public with the opportunity to share in the success and growth potential of AA. These objectives will frame our discussion of each of the monetisation alternatives considered.

1.1 FRAMEWORK FOR EVALUATING EACH OF THE MONETISATION ALTERNATIVES

Hong Kong International Airport (“HKIA”) is a world-class asset, renowned for its service quality and efficiency, and is strategically positioned as the gateway to the most dynamic and fastest growing region of the world. Superior operating efficiency and a highly effective crisis response to SARS attest to the quality, strength and vision of the management team. The proposed partial privatisation will be a landmark transaction, generating substantial interest from investors in Hong Kong and globally.

There are a range of monetisation alternatives, including privatisation via IPO, that are potentially available to the Government of Hong Kong Special Administrative Region (“HKSARG” or the “Government”) in respect of AA. In developing the optimal monetisation alternative, we have measured each option against a defined set of criteria, as outlined below.

Valuation of equity/proceeds	<ul style="list-style-type: none"> ◆ Maximise valuation/proceeds within the selected monetisation alternative
Continued role of Government	<ul style="list-style-type: none"> ◆ Reaffirm commitment to a free market economy and minimise the need for Government financial input; enhance AA’s independent access to equity capital ◆ Ensure that an acceptable level of HKSARG influence and control is retained ◆ Maximise the value and liquidity of the Government’s residual holding
Ownership	<ul style="list-style-type: none"> ◆ Encourage broad investor participation ◆ Share AA’s success and growth potential with the Hong Kong public
Impact on key stakeholders	<ul style="list-style-type: none"> ◆ Government: Optimise the utilisation of scarce public resources ◆ AA: Impact of monetisation option on AA’s management and business, including level of commercial discipline, drive and focus, and access to a range of funding sources ◆ Users: Impact of monetisation option on airline and other users ◆ Potential investors: Impact on investor demand
Development of Hong Kong and HKIA	<ul style="list-style-type: none"> ◆ Provide the platform to secure HKIA’s status as the leading regional aviation hub ◆ Attract new capital to Hong Kong ◆ Promote development and diversity of domestic capital markets
Ability to implement; ease of execution	<ul style="list-style-type: none"> ◆ Selected monetisation strategy should be easy to implement ◆ Legal implications (e.g. AA Ordinance / amendments required) ◆ Minimise execution risk

Introduction

1.2 RATIONALE FOR AIRPORT PRIVATISATIONS

In reviewing the rationale for precedent airport privatisations, several common themes consistently emerge, some of which are more applicable to AA and Hong Kong than others.

Firstly, airport privatisation can facilitate the use of private capital to fund the future investment requirements of a strategic national asset.

While AA is a relatively new airport with ample capacity, it is also growing very rapidly and will in the medium be in need of new capital to enable it to make continuous investments in HKIA and maintain its competitive edge. A privatisation will diversify and broaden AA's access to capital markets and also provide it with additional discipline in making timely and effective investments.

Secondly, privatisation provides a clear and determined signal of government's desire to reduce its participation in a market economy. Privatisation of airports is a key and growing trend in China, Asia and other parts of the world. In Hong Kong, the SAR Government has always adhered to the principle of "small government" in the belief that this will lead to better and more efficient allocation of resources.

Thirdly, in the case of privatisation via IPO, this allows for the broad distribution of ownership and provides a diversified source of funding for airports through access to deep and liquid equity markets. We anticipate that the privatisation of AA will allow the Hong Kong public to participate in the growth and success of this important asset.

Fourthly, privatisation generates proceeds to satisfy government funding requirements and provides the government with the flexibility to redirect public funds towards other purposes such as healthcare and education. This need in Hong Kong for Government income is much less acute than in other countries and hence is not an overriding consideration.

Finally, privatisation can enhance the commercial discipline and focus of airport operations, thereby motivating staff to drive increased operational efficiency, service standards and profitability. Private management and ownership is likely to enhance the ability to respond swiftly to changing market conditions. It will also be more responsive to commercial opportunities and subject to a supportive economic regulatory framework, encourage development of complementary businesses.

It has been questioned whether there was any urgent need to privatise AA given that it already delivers high commercial and operating standards, and that therefore any benefits are likely to be less prominent. Notwithstanding the merits outlined above, we believe there are tangible benefits for the stakeholders of AA in a privatisation for the following reasons:

- ◆ The market provides a level of scrutiny and a prompt, transparent reward-penalty system that cannot be replicated and hence encourages continuous improvement and innovation
- ◆ Privatisation will better position AA to fully leverage its airport management skills to develop commercial opportunities in the mainland and elsewhere
- ◆ AA's performance-oriented culture will be better sustained as a private enterprise
- ◆ Continued development of AA's business will create more varied job opportunities, providing AA's staff with better career prospects and job satisfaction

1.3 KEY STAKEHOLDER CONSIDERATIONS

Government and public

- ◆ Is there substantial future infrastructure investment required in AA's case that can be funded by the private sector?
 - Access to the equity capital markets will diversify AA's funding base

Introduction

- ◆ Will privatisation enable the more efficient utilisation of scarce public resources?
 - While AA already has access to debt capital, privatisation will allow AA also to tap equity capital, thereby reducing the likelihood of “cash calls” from Government, should these arise
- ◆ Will privatisation promote the regional and economic development of Hong Kong, the depth and diversity of domestic capital markets, and the status of HKIA as a regional aviation hub?
 - The privatisation method chosen will drive a number of these benefits
- ◆ What is the optimal strategy that maximises sale proceeds within the relevant constraints?
 - The optimal strategy will be determined with reference to, inter alia, AA’s business, and its prospects, and the desired level of Government control
- ◆ How can the Government exercise reasonable powers over this strategic asset?
 - Governments around the world have used a number of methods when privatising their airports including aerodrome licenses and economic regulation

AA

- ◆ Will privatisation maximise commercial discipline and focus, financial independence, returns and management autonomy?
 - Yes, within the bounds of AA being a strategic national asset
- ◆ Does privatisation facilitate AA’s ability to preserve its regional leadership while providing the platform to build first-class facilities to meet demand?
 - Yes, access to the equity capital markets will diversify AA’s funding base and impose capital discipline
- ◆ Can privatisation help motivate management, staff and employees to strive for excellence?
 - Yes, privatisation, in particular via IPO, can include employee and management performance-related benefits and incentive schemes that better align employee, company and shareholders’ interests
- ◆ Does privatisation provide access to additional sources of capital (e.g. equity)?
 - The extent depends on the privatisation route chosen

Users

- ◆ Can privatisation encourage the timely development of high quality infrastructure and the quality of service, safety and efficiency provided by HKIA?
 - Yes, AA’s team will continue to build on these key deliverables post privatisation
- ◆ Will privatisation simply replace a “public monopoly” with a “private monopoly”?
 - Economic regulation and competition from other airports should ensure that there is no monopoly abuse
- ◆ Will airport charges be reasonable post-privatisation?
 - From an economic perspective, AA should be allowed to earn a reasonable rate of return on its assets. The “reasonableness” of charges will need to be measured in the context of overall quality of service and efficiency

Potential Investors

- ◆ How attractive is AA’s investment proposition?
 - The business is very attractive; value depends on, inter alia, AA’s financial profile going forward and prevailing market conditions at the time of privatisation
- ◆ Does the investment opportunity satisfy investor return requirements?
 - This will depend on AA’s financial profile and risk associated with its projected cash flows

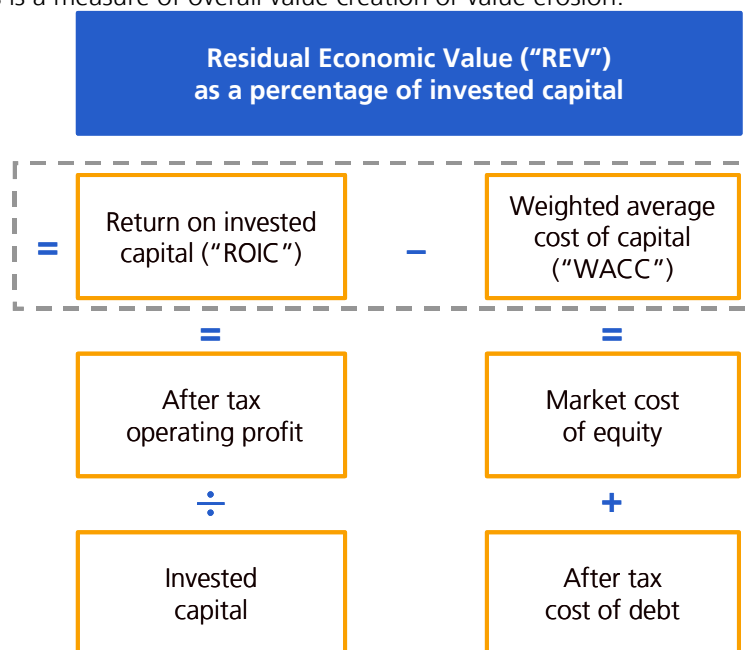
SECTION 2

The importance of capital structure

The importance of capital structure

AA's management has achieved significantly improved results over the past few years and is continuing to do so. Shareholder value can be further enhanced by focusing on minimising the cost of capital, usually referred to as the weighted average cost of capital ("WACC"). This will require optimising the mixture of debt and equity in AA's capital structure.

As brief background, capital structure efficiency is often measured by comparing a company's return on invested capital to its cost of capital. The difference between these two figures is called the Residual Economic Value; this is a measure of overall value creation or value erosion.



Effects of sub-optimal capital structure

Overcapitalisation (excessive equity)

- ◆ Too much equity will result in an unnecessarily high WACC and a low return on equity
- ◆ A high cost of capital may result in under-investment
- ◆ Projects/acquisitions will have difficulty passing the required return threshold and the company will therefore be less aggressive/competitive in the pursuit of new projects

Undercapitalisation (excessive debt)

- ◆ This will impose restrictions on the business' ability to finance for new investments
- ◆ If there are severe unforeseen shocks, the ability of the business to service its debt may be strained and in the extreme, would lead to creditors demanding loan repayment

A rebalancing of AA's debt and equity to optimise its capital structure will enhance its capital efficiency and shareholder's value.

SECTION 3

Methods of reducing Government equity ownership

Overview

We have considered the following monetisation options for the potential privatisation of AA:

- a) Initial Public Offering ("IPO") on the Stock Exchange of Hong Kong
- b) Sale of a minority stake (<50%) of AA to a strategic investor
- c) Securitisation
- d) Exchangeable bonds
- e) Sale to EFIL

We believe that options c), d) and e) do not fulfill Government's stated objectives as described in Section 1 and we have therefore not discussed them further in this paper. In the following pages we have evaluated each of options a) and b) in more detail according to the framework described in Section 1.

SECTION 3.A

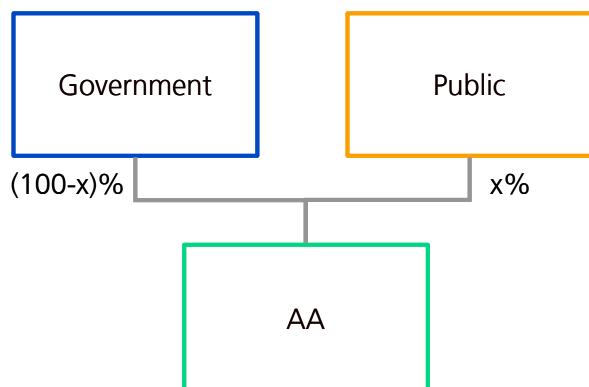
Methods of reducing Government equity ownership

IPO

IPO

1. TRANSACTION STRUCTURE AND TIMING

Transaction structure



Key features

- ◆ The Government launches an initial public offering for AA on the Hong Kong Stock Exchange (“HKSE”)
- ◆ Flexibility on amount of shares Government can sell; ability for company to raise new equity
- ◆ Key considerations include:
 - Suitability of the business for listing
 - Offer structure and size
 - Corporate governance
 - Employee and Hong Kong retail participation programmes

Indicative IPO timetable¹

Week	1	2	3	4	5	6	7	8	9	10	11	12
Documentation / Due diligence	[Yellow bar]											
Preparation of accounts	[Yellow bar]											
Financial modelling / valuation		[Green bar]										
Development of investment case		[Green bar]										
Pre-marketing									[Blue bar]			
Roadshow / bookbuilding											[Blue bar]	
Pricing												◆

Note:

1 Assumes AA is corporatised and regulation is in place prior to launch

2. MEASURING AN IPO AGAINST KEY CRITERIA

- ◆ **Valuation** — Value will be driven by the future prospects of AA, which will in large part be determined by the agreed regulatory framework, corporate governance, capital structure etc. Maximum sale proceeds will be difficult to achieve as no “control premium” (which a single buyer may be prepared to pay) is justified
- ◆ **Continued role of Government** — An IPO structure gives the Government the flexibility to retain a majority residual stake in AA and maximises the liquidity of the Government’s residual shareholding
- ◆ **Ownership** — An IPO facilitates substantial participation by employees and domestic retail investors in a strategic national asset
- ◆ **Impact on key stakeholders** — The Hong Kong public and investors will be familiar with the IPO structure, given the MTRC precedent. In respect of AA’s management and business operations, broad private ownership and disclosure and public scrutiny as a listed entity will enhance commercial focus, drive for operational efficiency and management accountability, and increase business autonomy and financial flexibility at AA. Management incentive programmes, based on public market benchmarks, may also be introduced to align management and shareholders’ interests
- ◆ **Ability to implement and ease of execution** — As with any other monetisation option, a degree of execution risk is involved. This is particularly the case for IPOs, given the sensitivity of a successful equity issue to prevailing market conditions and investor sentiment

- ◆ **Legal implications** — An IPO would require the corporatisation of AA with the associated legislative changes and the vesting of its property, assets and liabilities into the ListCo. As per the views of legal advisers, the formula of statutory vesting of all rights and liabilities of the existing Airport Authority in a Cap.32 company, whose shares can then be sold to outsiders, is tried and workable (e.g. MTRC) and is far simpler and more effective than attempting to transfer rights and liabilities by any other means. The major legal implication is ensuring that all consequential necessary legislative and regulatory amendments are identified and dealt with. Similarly any impact on international agreements will need to be identified and any necessary steps taken to ensure compliance with Hong Kong's obligations. If any change in international obligations is envisaged, Basic Law 13 needs to be borne in mind to see whether it might have any application (Central People's Government responsibility for Hong Kong's foreign affairs)
- ◆ **Development of Hong Kong and HKIA** — An IPO increases the international profile and visibility of AA, establishes a deep future funding platform for AA and increases the depth and diversity of the Hong Kong equity market

3. OTHER CONSIDERATIONS

◆ **Size of offering**

An important consideration in determining the size of the IPO is the Government's desired residual shareholding and level of control. We expect that the Government will seek to maintain a reasonable level of control over AA given its strategic importance to Hong Kong and the domestic economy. In the case of a partial IPO, institutional investors will typically expect the Government to indicate its longer-term intention in relation to its residual stake. In the case of MTRC, the Government provided an undertaking in the prospectus that it intended to retain at least 50% of the company for a period of 20 years post-IPO. From an international perspective, it is not common for governments to commit for such long periods of time. The Government may also wish to consider the implementation of additional control mechanisms, particularly if an IPO of a majority stake is selected as the preferred privatisation strategy, including a single shareholder limit or foreign ownership limit. The flipside of this is that such restrictions are likely to have an impact on value as they would eliminate the possibility of a takeover.

◆ **Impact on credit rating**

Recent rating agency actions in Europe with regard to both ADP and Schiphol suggest that the agencies are adopting a more conservative approach to airport ratings by evaluating them on a stand-alone basis (i.e. without Government support). However, in Asia, we understand that the linkage between government-owned companies and sovereigns remains strong.

◆ **Maximising value in the IPO**

From an implementation perspective, a well-structured and executed IPO will maximise value for the Government and AA. In order to maximise valuation at the time of IPO, a number of important considerations must be addressed, including:

- Offer and syndicate structure should be designed to maximise the efficiency of the marketing and execution process. 2-3 Joint Global Coordinators / Joint Bookrunners could be appointed to lead both the Institutional Offer and the HKPO. Key selection criteria should include knowledge and understanding of AA, marketing and distribution strength, demonstrable ability to generate demand of the highest value for issuers, credibility and rankings of research analysts, and experience in executing similar offerings globally and in Hong Kong
- Offer size: This needs to be sufficiently large to facilitate the participation of key investors and ensure adequate liquidity in the secondary market, whilst not being too large for the market to absorb
- Marketing campaign:
 - Institutional investors will provide price leadership in an IPO and will drive demand and valuation

IPO

- Given the familiarity of Hong Kong retail investors with AA, retail demand will be strong and can be maximised through the use of a comprehensive targeted marketing programme (including the use of marketing materials, call centre, website and potentially, retail incentives)

◆ Listing venue

We believe that a Hong Kong listing is adequate for AA. We do not believe that a dual listing will add to the success of a potential IPO, or increase the achievable offer size or valuation of AA. Neither the MTRC or BOCHK IPOs involved an overseas listing; Grupo Aeroportuario del Sureste SA (ASUR) in Mexico is the only airport IPO to have chosen the dual listing route. There were a number of specific reasons for this including the limited depth of the domestic market, the inability of foreign institutions to invest in securities listed in Mexico and the desire to embrace US GAAP and SEC disclosure and corporate governance requirements.

SECTION 3.B

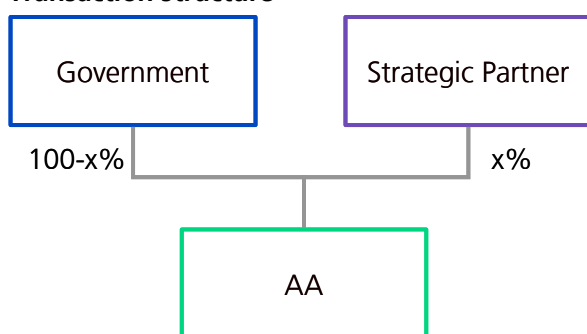
Methods of reducing Government equity ownership

Sale of a minority stake to a strategic investor

Sale of minority stake to a strategic investor

1. TRANSACTION STRUCTURE AND TIMING

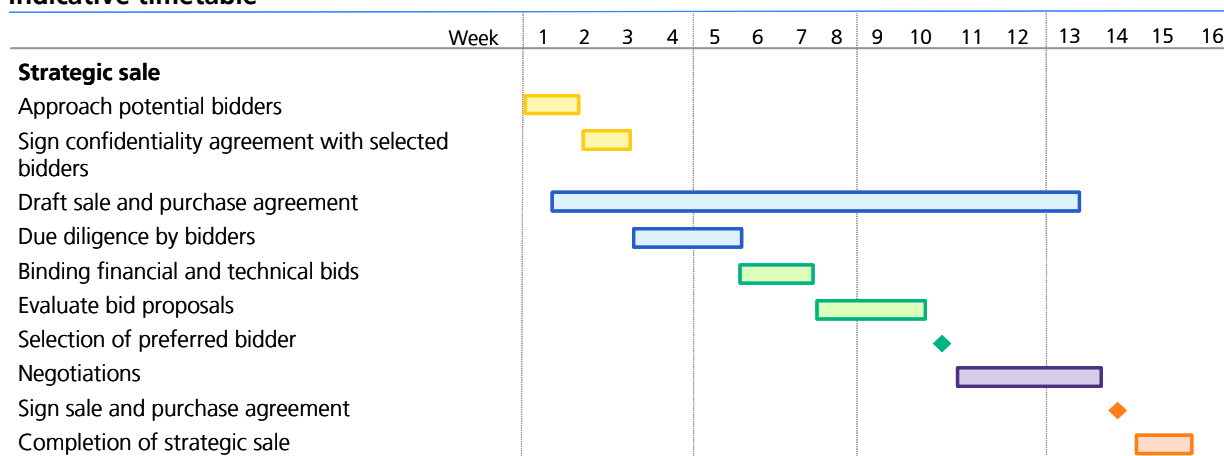
Transaction structure



Key features

- ◆ The Government sells a minority stake in AA to a strategic partner and retains the remaining stake
- ◆ A new corporate structure for AA is preferable
- ◆ Third party interest likely to be driven by associated preferential trading relationships
- ◆ May draw interest from “trophy asset” hunters

Indicative timetable



A strategic stake of less than 50% will not deliver full control to a strategic investor. Parties interested in such a stake are likely to seek to use it to secure preferential trading or other relationships with HKIA. From their perspective, they are likely to seek the lowest possible monetary investment to secure the aforementioned relationship. However, the level of strategic stake held by a third party will have very different implications for HKSARG as the holder of the remaining shares.

2. MEETING GOVERNMENT’S OBJECTIVES

- ◆ **Valuation** — The sale of a minority stake in a corporatised AA is unlikely to achieve a higher valuation than an IPO unless the Government is willing to concede meaningful management influence or a path to control. The Government may nevertheless secure part of the monetary value of the preferential trading or other relationships with HKIA that the buyer may secure in return. In addition, there have been precedents where premia have been paid for the scarcity value of investment opportunities (e.g. ADP Management in Beijing Capital International Airport)
- ◆ **Continued role of Government** — A strategic sale process offers the flexibility for the Government to IPO the remaining stake at a later date

Sale of minority stake to a strategic investor

- ◆ **Ownership** — A strategic sale process results in highly concentrated ownership. As far as the level of ownership is concerned, potentially interested strategic buyers will see little benefit in acquiring a large stake to secure preferential trading or other relationships with HKIA. We believe that a 10% stake would be deemed sufficient for this purpose, while a 20% stake would have the additional benefit of equity accounting. A stake in excess of 25% would give the strategic buyer the power to block special resolutions, but negative control is not deemed sufficient to generate interest among airport operators and may not be acceptable to the Government either
- ◆ **Impact on key stakeholders** — The limited tangible value-add to AA from an operational perspective and the acceptability of the potential strategic partner to the Government, AA and the general public, are key considerations
- ◆ **Ability to implement and ease of execution** — The sale process is less dependent on equity market conditions, which substantially reduces execution risk
- ◆ **Legal implications** — It may be technically possible for the Government to transfer some of its shares in AA to a strategic investor with only certain amendments to the existing Ordinance to allow for the introduction of the additional shareholder, the payment of dividends, the appointment of a Board representative(s) and other related matters. However, it may be desirable from both the Government's and the investor's perspective for AA to be corporatised prior to the strategic sale, which will involve the repeal of the existing Ordinance and the enactment of a new ordinance
- ◆ **Development of Hong Kong and HKIA** — Given the strength of AA's management team, operational efficiency, world-class facility and service standards, a strategic partner will offer little additional value in terms of international profile or operational, management and efficiency gains. On the contrary, a strategic buyer's commercial expectations for management influence will likely create substantial and unnecessary disruption to the management and operation of HKIA. Finally, this option does not allow for the broad ownership of AA, a key objective of the privatisation exercise

APPENDIX A

Selected international precedents

Selected international precedents

We present below monetisation methods pursued by other governments in respect of airport assets worldwide.

	No. of airports	Date	IPO	Sale of minority stake	Sale of majority stake
Argentina	33	1998			✓
Athens	1	1995		✓	
Auckland	1	1998	✓		
Australia I	3	1997			✓
Australia II	7	1998			✓
BAA	7	1987	✓		
Beijing	1	2000	✓		
Birmingham	1	1997		✓	
Bolivia	1	1996			✓
Bristol	1	1997			✓
Brussels	1	2004		✓	
Chile	3	1997			✓
Colombia	3	1996			✓
Copenhagen	2	1994	✓		
Düsseldorf	1	1997		✓	
East Midlands	1	1993			✓
Fraport	2	2001	✓		
Florence	1	2000	✓		
Guangzhou Baiyun	1	2003	✓		
Hainan Meilan	1	2002	✓		
Hanover	1	1998		✓	
London Luton	1	1998			✓
Malaysia Airports	36	1999	✓		
Mexico	34 ¹	1998	✓	✓	
Newcastle	1	2001		✓	
Rome ²	2	1997	✓		✓
Sangster Jamaica	1	2003			✓
Shanghai	1	1998	✓		
Shenzhen	1	1998	✓		
South Africa	9	1998		✓	
Sydney	1	2002			✓
Vienna	1	1992	✓		
Wellington	1	1998			✓
Xiamen	1	1996	✓		
Zurich	1	2000	✓		

Notes:

- 1 Three regional airport groupings privatised in 1998, 1999 and 2000 involving 34 airports
- 2 ADR was taken private in 2000 by the Leonardo consortium, which acquired a majority stake via a tender process that triggered a mandatory public offer for 100% of the company

Economic regulation paper

January 2005

Disclaimer

UBS AG ("UBS") was engaged by the Government of the Hong Kong Special Administrative Region ("HKSARG" or the "Government") to provide independent advice on the feasibility of partial privatization of Airport Authority Hong Kong ("AA"). Our financial advice, under the terms of our engagement contract, was contained in various reports to HKSARG (the "Reports"). The information and analyses contained in, and opinions expressed in, the Reports were based, among other things, upon confidential information provided to UBS by Government and AA.

This document is an abridged version of the Reports produced at the request of the Government. Given that the analysis underlying some elements of the report has been based on sensitive information, sections containing or referring to such sensitive information have been omitted from this abridged version. Accordingly, this document does not purport to or necessarily contain all the information that may be necessary to fully evaluate the feasibility of a partial privatisation.

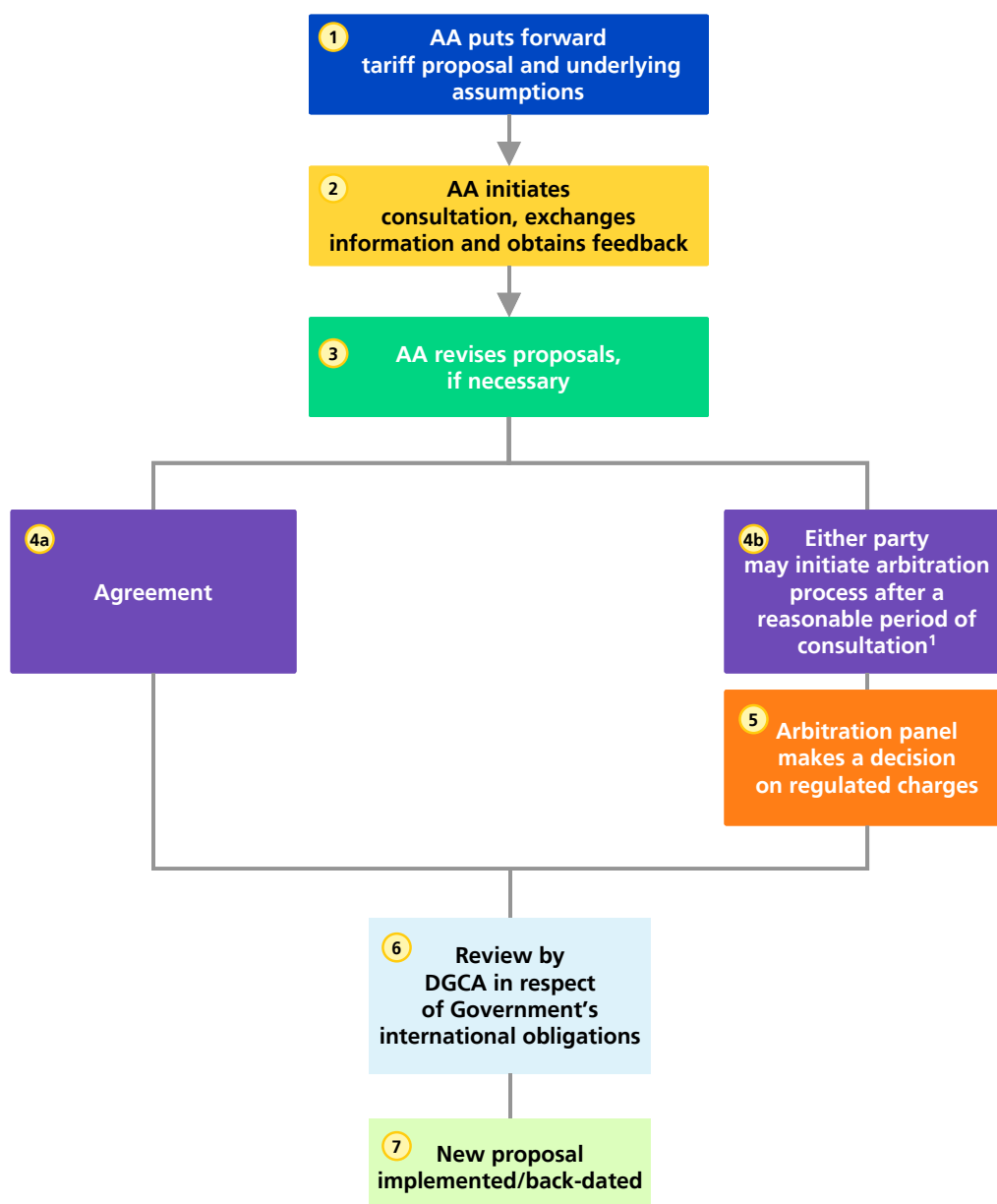
No representation or warranty, expressed or implied, is or will be made in relation to the accuracy, fairness, reasonableness or completeness of any information contained in this document or that any information remains unchanged in any respect. No responsibility or liability is or will be accepted by UBS or by any of its officers, employees, advisors and agents in relation thereto and accordingly none of them shall be liable for any cost, loss or damage incurred or suffered by any recipient or any other person in connection with or arising out of the use of this document or any reliance placed thereon. Information included in this document is based on the conditions prevailing at the time of the partial privatisation study and may be subject to change or amendment to reflect changing circumstances.

Proposed price setting mechanism

This section sets out the possible mechanics for price setting by AA within the scope of the proposed economic regulatory regime. It is envisaged that the new AA Ordinance will contain provisions which will empower AA to levy airport charges and detailing:

- ◆ The guiding principles that AA should respect when setting airport charges
- ◆ The procedures that AA should follow in order to do so, as described below. Such procedures may or may not be in the revised AA Ordinance. If not, then they may be contained in a separate document and reference be made to this document in the revised AA Ordinance
- ◆ The identity, role and remit of the regulator

The schematic below outlines the broad steps that are envisaged and a summary of the detailed considerations follows.



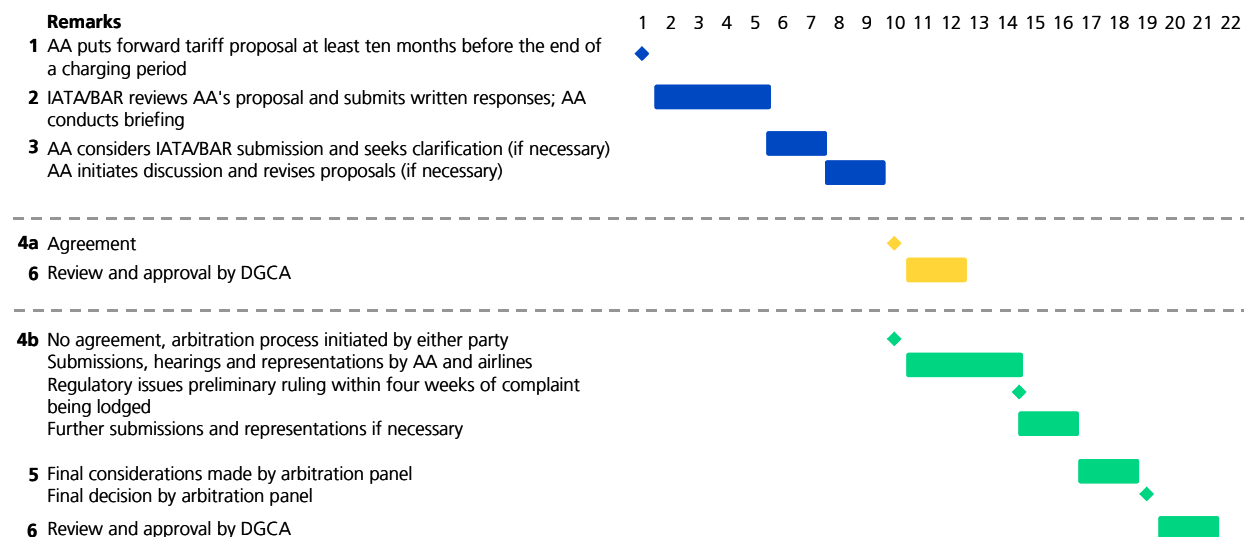
Note:

- 1 Both parties can terminate the arbitration process at anytime in the process by mutual agreement

Proposed price setting mechanism

Indicative timetable

(weeks)



1. AA puts forward tariff proposal and underlying assumptions

- ◆ The central tenet of the proposed price setting mechanism is the consultation process undertaken by AA, which should provide a forum for AA and airlines to share and exchange their views. A proper consultation process is one in which AA seeks to share in advance the relevant information, allow for sufficient time for review, enter into meetings with an open mind to take due notice of the users' point of view, and consider this view before making a decision
- ◆ In terms of parties to consult, to avoid an unwieldy and costly process, it is suggested that airlines, as represented by IATA and BAR, are consulted.
- ◆ Ten months before the end of a charging period, AA should put forward a proposal to IATA/BAR on the new charges to be applied in the subsequent period, which can range between three and five years. The proposal is also sent to the Director General of Civil Aviation ("DGCA") for information only
- ◆ This will be necessary even if AA does not intend to change its charges—it cannot assume that the old charges will continue indefinitely without consultation with its customers
- ◆ AA will need to adhere to the guiding principles of charge setting as enshrined in the revised AA Ordinance, which would define the regulatory activities and other broad parameters. In developing its tariff proposal, AA will be required to take into account the following:
 - Macro-economic assumptions, including GDP growth and inflation and their impact on AA regulated business (including traffic, revenues and costs)
 - Traffic and capacity forecasts (taking into account advice and opinion from third party consultants)
 - Achievable efficiency improvements and likely developments of unit costs
 - Level of service standards
 - Price caps over the proposed period, ensuring that expected return on RAB caps will not exceed the target rate of return
 - Competitiveness of HKIA
 - Other commercial considerations

Proposed price setting mechanism

- ◆ AA's tariff proposal to IATA/BAR should contain a detailed review of the previous period including the regulatory return, efficiency gains, service levels achieved and rebates, if any, these airlines are entitled to as a result of sub-standard services
- ◆ The proposal should also contain relevant business information/projections related to the regulated activities for the next period, including the proposed price caps and detailed justification and analysis for such price caps, namely:
 - Key macro-economic assumptions
 - Business forecasts (including traffic, capacity, unit costs, etc.)
 - Capex plan
 - Forecast aeronautical accounts
 - Service standards commitments

2. AA initiates consultation, exchanges information and obtains feedback

- ◆ Within four weeks, IATA/BAR would submit their written responses to AA, with detailed arguments on elements of the proposal they do not agree with and any alternatives they might want to propose
- ◆ If no submissions from IATA/BAR were made to AA in the four weeks after initial publication and submission, AA's proposal is deemed to be accepted by airlines
- ◆ The following points are also noted:
 - Information sharing should be a two-way process, for example, airlines may need to share their business projections (such as load factors and capacity changes) with AA
 - Any parameters and measurements should be defined and agreed between AA and airlines to minimise future dispute
 - Activities outside the defined scope of regulatory activities should not be open for consultation
 - Confidentiality undertakings

3. AA revised proposal and initiates discussion process if necessary

- ◆ In the event that IATA/BAR submits a considered response, AA should review it and seek clarifications, if necessary in Weeks 5 and 6. AA may wish to consider revising its proposal following comments from AAB and IATA/BAR
- ◆ Thereafter, AA would initiate a discussion process with IATA/BAR on the outstanding issues with a view to achieving an agreement as soon as possible
- ◆ AA should also notify AAB and the DGCA of the outcome of the consultation process with IATA/BAR once an agreement is reached

4.A Agreement

- ◆ Once a commercial agreement has been reached, neither the arbitration panel nor Government can interfere with the decision (subject to Step 6)

4.B Non-agreement

- ◆ At any time of the consultation process after a reasonable period of consultation, AA and IATA/BAR may seek a review from the arbitration panel and propose alternative proposals, if they wish. They may also terminate any review process by mutual agreement

Proposed price setting mechanism

- ◆ Either AA or IATA/BAR could lodge a referral with the arbitration panel. If more than one referral is lodged, the arbitration panel will seek to address all referrals in one review (instead of a series of reviews)
- ◆ The arbitration panel should have discretion in determining if a referral is valid, in particular, he may wish to pay particular attention to whether or not:
 - AA has followed the stated procedure as described in the revised AA Ordinance or related documents (e.g. AA failed to clarify IATA/BAR's questions on its proposal)
 - Part or all of AA's proposal may be in breach with the revised AA Ordinance (e.g. rate of return will be above the target rate of return)
 - The assumptions and forecasts used by AA are appropriate and internally consistent

5. The arbitration panel makes a decision

- ◆ Should the arbitration panel determine that there is cause for referral, a formal review will be launched to arbitrate between the two parties. The arbitration panel will seek views and clarifications from both parties and, if appropriate, ask for further details, evidence or clarifications from AA and/or IATA/BAR. At its own discretion, the arbitration panel may also draw upon external expertise in forming a view
- ◆ One month after the review process is initiated, the arbitration panel is expected to provide a preliminary ruling, having taken into account the representations from AA and IATA/BAR. Both parties will have an opportunity to submit further representations within two weeks of this preliminary judgement
- ◆ The arbitration panel must provide a balanced view and any judgements made must take into account all relevant factors, including the guiding principles, Hong Kong's competitiveness, economic growth and other factors outlined in Step 1 above. He may rule that:
 - AA was not in breach of the guiding principles of charge setting and its proposal was based on reasonable assumptions and due process and hence it should be implemented
 - AA did breach the guiding principles or that the reasonableness of its assumptions was questionable, in which case the arbitration panel may:
 - Decide the review in IATA/BAR's favour and adopt its alternative proposal
 - Come up with an alternative proposal
- ◆ The final decision, together with its findings and rationale, will be publicly announced and published within two months of receiving a referral. Under exceptional circumstances, an extension of one month may be granted by the SEDL
- ◆ In order to achieve the balance of providing regulatory backstop and preventing unnecessary dispute, the cost of the arbitration should be borne by both AA and IATA/BAR. One way to make it more equitable would be for IATA/BAR to bear the majority of the cost (say, two-thirds) if the arbitration panel found in favour of AA, with the rest of the costs borne by AA. Should the arbitration panel rule in favour of IATA/BAR, the charging arrangement will be reversed. Should the arbitration panel propose an alternative solution, the cost could be split equally. An alternative to the above is to allow the arbitration panel the discretion to apportion the costs as it sees fit

6. Review by DGCA in respect of Government's international obligations

- ◆ Following a determination by the arbitration panel, AA should submit its proposal to DGCA for vetting for compliance with relevant international obligations
- ◆ The final proposal should be submitted to the DGCA, who has the power to veto its application if it believes that the proposal breaches Government's international obligations. In this case, either AA or the arbitration panel would be duty bound to alter their proposal until the DGCA is satisfied that Hong Kong's international obligations will be fully discharged

Proposed price setting mechanism

7. New proposal implemented

- ◆ The new proposal will be implemented at the onset of the charging period or back-dated to the date when the charging period should have taken effect

Comparison with Hong Kong International Airport

	2002 pax traffic (m)	2002 Cargo traffic (' 000)	No. of airlines serving	Destinations served
Hong Kong	33.9	2,505	75	143
Auckland	9.1	188	29	47
BAA ¹	63.3	1,311	88	172
Beijing	27.2	669	44	110
Copenhagen	18.3	374	54	109
Fraport ²	48.5	1,515	112	230
Guangzhou	16.0	593	21	76
Vienna	12.0	124	55	119

	2003 pax traffic (m)	2003 Cargo traffic (' 000t)	No. of airlines serving	Destinations served
Hong Kong	27.1	2,669	72	136
Auckland	9.8	207	29	50
BAA ¹	63.5	1,300	93	174
Beijing	24.4	662	50	117
Copenhagen	17.6	336	58	125
Fraport ²	48.4	1,550	109	227
Guangzhou	15.0	544	25	84
Vienna	12.8	127	54	130

Notes:

- 1 Statistics of flagship London Heathrow Airport shown
- 2 Statistics of flagship Frankfurt Am Main Airport shown

Source: Air Transport Intelligence, company reports

Traffic throughput for selected privatised airports

Year	-1	0 ¹	1	2	3	CAGR ²
Passengers (million)						
Auckland	7.6	7.5	7.7	8.0	8.4	2.6%
BAA	53.4	55.3	63.7	68.0	71.3	7.5%
Copenhagen	12.9	14.1	15.0	16.1	17.1	7.3%
Fraport	49.4	48.6	48.5	48.4	51.1	0.8%
Vienna	5.8	6.8	7.2	7.7	8.5	9.8%
Cargo ('000 tonnes)						
Auckland	189.9	193.5	186.3	191.7	187.0	-0.4%
BAA	835.0	864.0	952.0	1,021.0	1,090.0	6.9%
Copenhagen	243.5	273.5	309.8	338.0	387.7	12.3%
Fraport	1,730.4	1,635.2	1,656.0	1,550.0	1,750	0.3%
Vienna	86.1	94.5	99.5	113.9	125.8	9.9%
WLU³ (million)						
Auckland	9.5	9.4	9.5	9.9	10.3	2.1%
BAA	61.8	63.9	73.2	78.2	82.2	7.4%
Copenhagen	15.3	16.8	18.1	19.5	20.9	8.1%
Fraport	66.7	65.0	65.1	63.9	68.6	0.7%
Vienna	6.7	7.7	8.2	8.8	9.8	9.8%

NOTES:

1 Year 0 is the privatisation year.

2 Compound annual growth rate.

3 WLU means work load unit, which is used by airports to measure the total throughput (i.e. passenger + cargo traffic). One WLU is equal to one passenger or 100kg of freight.

The Scale of Airport Charges

‘Airport Charges’ has the same meaning as defined in the Airport Authority Ordinance and includes the Landing Charge, Parking Charge, and Terminal Building Charge. The calculation of these three charges is set out as follows.

(a) Landing Charge

2. The Landing Charge for each landing of an aircraft other than a helicopter shall be calculated as follows:-

- (i) where the MTOW¹ of the aircraft does not exceed 20 tonnes, a sum of HK\$2,210; or
- (ii) where the MTOW of the Aircraft exceeds 20 tonnes, a sum being the aggregate total of HK\$2,210 plus HK\$63 for each tonne in excess of 20 tonnes.

(b) Parking Charge

3. The Parking Charge for the parking of an aircraft other than a helicopter in the Other Areas² shall be calculated by the applicable Parking Unit Rate times the number of applicable Parking Units for which the aircraft has parked at the parking stand.

4. The rate for each Parking Unit³ for the parking of an aircraft other than a helicopter at the following parking stands shall be⁴:

¹ MTOW means, in relation to any aircraft, the maximum take-off weight (expressed in tonnes) as set out in the current Certificate of Airworthiness or flight manual or operations manual for the aircraft concerned at the material time, whichever is the greatest.

² ‘Other Areas’ means the Airport Area other than the Business Aviation Designated Apron Area.

³ A Parking Unit for parking at a parking stand is each period of 15 minutes.

⁴ For parking at all types of parking stands in the Other Areas between mid-night and 07:00 (or any part thereof), the parking charges depend on whether Ground Handling Services are required. ‘Ground Handling Services’ means the services for or in connection with the handling of passengers, baggage, cargo, or mail performed at the Airport Area.

	<i>Parking Stand</i>	<i>Rate per Parking Unit</i> <i>HK\$</i>
(1)	Terminal building frontal parking stands	156
(2)	Terminal building remote parking stands	125
(3)	Cargo apron parking stands	99
(4)	Maintenance apron parking stands	80

(C) Terminal Building Charge (“TBC”)

5. The TBC shall be calculated as follows:

HK\$23 times the number of passengers on the aircraft departing from the Airport Area and who are not transit passengers.