

**For discussion
on 23 February 2004**

Legislative Council Panel on Economic Services

Privatization of Airport Authority

Introduction

On 6 August 2003, the Administration announced that we would commence work in preparation for the proposed privatization of the Airport Authority (AA). In the past few months, we have studied various privatization options and considered the key issues relating to privatization. We have initially come to a view on the way forward for the proposed privatization and would like to brief Members before proceeding further. We now propose that as a first step, AA should return about \$6 billion of equity capital to Government through capital restructuring prior to privatization.

Background

2. AA is currently a statutory corporation set up pursuant to the AA Ordinance (Cap. 483). While it is wholly owned by the Government and all members of its Board are appointed by the Chief Executive, AA is required by statute to conduct its business according to prudent commercial principles. In terms of safety and security, AA has to obtain an aerodrome licence from Director-General of Civil Aviation (DGCA) under the Air Navigation (Hong Kong) Order 1995 (Cap. 448 sub. leg. C). In this respect, DGCA is the regulator of safety and security at the Hong Kong International Airport (HKIA) and is responsible for ensuring AA's compliance with international obligations.

Rationale for Privatizing AA

3. In pursuing partial privatization of AA, our 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 to strengthen Government finance in the short to medium term.

Privatization is in line with the Government's philosophy of "big market, small government". As a matter of principle, it should be pursued whenever the market is well placed to provide the service.

4. Foreign experience on airport privatization is mixed. It is not common in North America mainly due to regulatory and tax provisions which favour financing through the municipal bond market; and more recently national security concerns. On the other hand, airport privatization has been quite common in Europe, South America and, more recently, in Australia and Asia. Major international airports such as those in London, Frankfurt, Zurich, Copenhagen, Buenos Aires, Mexico City, Sydney, Auckland, Beijing, Shanghai, Guangzhou and Shenzhen have been privatized with varying forms of regulatory framework. Thailand and Tokyo have also recently announced their airport privatization plans.

Options for Privatization

5. Following the MTRC precedent, a logical arrangement for privatizing AA is through initial public offering (IPO) followed by a listing on the Hong Kong Stock Exchange. IPO is also commonly adopted when airports are privatized elsewhere. To ascertain whether this is the best choice for AA, the Government's financial advisors have analyzed several other options for privatizing AA, including sale to strategic investors, securitization, issue of exchangeable bond and sale to the Exchange Fund.

6. Generally speaking, all of these options also have the drawback of not conferring ownership of the airport on members of the public, hence do not build on the Government's privatization efforts. We have therefore decided that IPO should be the preferred mode of privatization.

7. To enable AA to be privatized by means of IPO, a new company will be formed under the Companies Ordinance (Cap. 32). All the assets, properties, rights and obligations of AA will be vested in this new company through a privatization bill, which will also set out the regulatory framework after privatization. After this corporatization process, the Government would launch an IPO and dispose of part of its shares in this new company by listing of the shares in the new AA on the Hong Kong Stock Exchange. At the same time, Government will retain appropriate powers over the privatized AA to ensure safe and efficient operation of the airport, and compliance with our obligations under the Basic Law¹ and other international treaties relating to civil aviation applicable to Hong Kong.

AA's Current Financial Situation

8. Before AA can be privatized through IPO, AA would have to demonstrate to investors its financial position as a business worthy of investment. Given the significant initial capital investment in the airport as well as the impact of the September 11 event and the outbreak of SARS on air traffic, the profitability of the airport (\$502 million in 2002/03) is so far only very modest relative to Government's equity of over \$36 billion. With the economic recovery and continued progressive extension of the individual visit scheme of

¹ The Basic Law provisions directly relevant to airport operations, with our own emphasis underlined, are –

Article 128 : The Government of the Hong Kong Special Administrative Region shall provide conditions and take measures for the maintenance of the status of Hong Kong as a centre of international and regional aviation.

Article 129 : The Hong Kong Special Administrative Region shall continue the previous system of civil aviation management in Hong Kong and keep its own aircraft register in accordance with provisions laid down by the Central People's Government concerning nationality marks and registration marks of aircraft.....

Article 130 : The Hong Kong Special Administrative Region shall be responsible on its own for matters of routine business and technical management of civil aviation, including the management of airports, the provision of air traffic services within the flight information region of the Hong Kong Special Administrative Region, and the discharge of other responsibilities allocated to it under the regional air navigation procedures of the International Civil Aviation Organization.

Mainland residents, the airport should be able to demonstrate stronger traffic growth and hence a better financial case in the near future, although at the same time, the airport would need to maintain its high standard of services and competitiveness in light of increasing competition from airports in the region. We will keep in view the financial situation of AA as we progress with the privatization exercise.

Optimizing AA's Capital Structure

9. In studying the privatization of AA, our financial advisors have observed that the present debt to equity ratio of AA is low compared to similar organizations. As the cost of debt is normally lower than the cost of equity, AA's low debt to equity ratio has resulted in relatively high weighted average cost of capital (WACC). Our financial advisors have advised that AA could optimize its capital structure to lower its WACC by returning to Government part of our over \$36 billion equity capital. This has a value-enhancement effect, although the eventual valuation of AA also hinges on a host of other factors including market conditions and expected growth prospect. Such capital restructuring has an added advantage of making available some capital revenue to Government prior to privatization. While AA would have to finance such return of equity by borrowing, our advisors estimate that an amount of about \$6 billion should not unduly affect its financial strength and credit rating, subject to the continuation of appropriate Government credit support mechanism, e.g. a majority Government ownership.

10. The additional borrowing by AA to finance a capital restructuring would increase its interest expenses and lower the amount of its net profits in the next few years. But the capital structure optimization would in the long term help improve AA's return on equity and make it more attractive to potential investors.

11. Taking the above into account, we intend to ask AA to return about \$6 billion of equity capital to Government prior to privatization. This would result in a debt to equity ratio of about 1:2 instead of the current ratio of about 1:4. Such an exercise requires simple amendments to the AA Ordinance. We will take forward the amendment bill for capital restructuring ahead of the privatization bill. This two-step approach would enable the capital restructuring to proceed early, so that AA could take advantage of the current low interest

environment to arrange the necessary financing. The proposed capital optimization would help enhance the business case of AA regardless of the final form and timing of the subsequent privatization.

Other Privatization Issues

12. As regards the privatization exercise, it involves a basket of regulatory issues which are more complex in nature. We have sounded out some stakeholders on their initial views during the past few months. There are issues which we will make further consultations on. After that, we will consult this Council. The concerns of the stakeholders on some specific issues as well as how we intend to deal with them are set out below—

- (a) Regulation of airport charges – while some people favour allowing the future AA as a listed company full autonomy in setting airport charges, many others suggested that there should be a defined mechanism to govern the adjustment of airport charges to prevent AA from abusing its monopolistic position and extracting undue benefits from its users. Airlines are concerned whether there are permissible 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 will devise a form of regulatory mechanism that would aim to address these concerns and at the same time provide sufficient commercial flexibility to the privatized AA for further consultation;
- (b) Service standards and efficiency – the public accords great importance to maintaining high service standards and efficiency at the airport. We will try to incorporate appropriate features in the price regulatory mechanism 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 with a vast amount of land under its control, some people are concerned about its unparalleled advantages in certain business activities and the risk of it engaging

in anti-competitive practices. We intend to allow flexibility for AA to conduct all airport-related activities subject to normal planning controls and land grant restrictions, but at the same time introduce statutory prohibitions against anti-competitive activities and abuse of dominant position by AA to address potential public concerns; and

- (d) Residual Government controls – the majority of stakeholders considered the airport a strategic facility and emphasized 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. We will devise a package of proposals that would strike a balance between the competing considerations.

13. The proposed regulatory mechanism as outlined above would need to be enshrined in the privatization bill and related regulatory documentation such as guidelines or codes of practice. We will further consult stakeholders including AA on the specific issues as set out in the Annex before finalizing the privatization bill together with other regulatory documentation. We will brief Members again after drawing up concrete proposals.

Annex

Timetable

14. Our present plan is to introduce the amendment bill for capital restructuring into this Council for First and Second Reading around late March 2004. The privatization bill will be prepared in parallel and we will review the timetable for its introduction into this Council after further consultations.

Views Sought

15. Members are invited to comment on the proposal to undertake capital optimization for AA. Members' views on other aspects concerning the privatization of AA is also welcome.

Economic Development and Labour Bureau/
Financial Services and the Treasury Bureau
February 2004

Issues for Further Consultation with Stakeholders

A. Economic Regulation

1. Basic principles – fair, user pays; predictable and stable; clear, simple and transparent; allow reasonable return; provide incentives for efficiency, service quality and investment; minimize administrative costs.
2. Scope of regulated activities – only those activities in the “monopolistic bottleneck”, i.e. those core airport activities which are necessary for the operation of airlines, but cannot be economically duplicated or produced outside the airport perimeter.
3. Permissible return – the return from regulated activities is to be capped, the exact level to be further determined. As AA would be free, subject to market conditions and statutory prohibitions (see item 9 below), to adopt any target return for the non-regulated activities, the AA’s overall return as a company could be above the cap.
4. Price setting – AA to draw up a set of price caps for airport charges for 3 to 5 years taking into account projected costs, revenues and capital expenditure relating to regulated activities and following consultation with airlines. The price caps could be set in different ways, e.g. with specific numbers, an inflation-linked formula, etc.
5. Service standards – AA to draw up a set of service standards at the same time as setting price caps for airport charges. Consideration could be given to a financial reward and penalty system to link the actual service standards to the level of airport charges.
6. Qualitative factors – notwithstanding the price caps, AA would have to explain how it has taken into account some qualitative factors such as competitiveness of the airport or general economy of Hong Kong before implementing any adjustment to airport charges.

7. Dispute resolution – an independent body would be established to adjudicate on any complaint from airlines against the setting of price caps by AA.

B. Scope of AA's business and competition

8. Subject to applicable laws, restrictions in the Land Grant and other Government regulations, the AA would be allowed to conduct any airport-related activities both on and outside the airport island.
9. Statutory provisions would be included in the privatization bill to prohibit AA from engaging in anti-competitive activities and abuse of its dominant position, modeling on similar provisions in the Telecommunications Ordinance (Cap. 106) and Broadcasting Ordinance (Cap. 562). The same independent body responsible for adjudicating on airport charges could also be tasked to deal with any complaints against AA's alleged breaches of these provisions.

C. Other Controls on AA

10. Government to appoint a minority number of members to the Board of AA to represent Government's interests, on top of any rights Government may have as a shareholder.
11. More than half of the members of the AA Board, excluding Government appointed directors, should be ordinarily resident in Hong Kong. The existing requirement for the AA Chairman to be a Hong Kong Permanent Resident would be retained.
12. Material interests in shares by any single shareholder (including associates), other than HKSAR Government, would be limited to not more than 10% of the issued shared capital.
13. The exercise of voting rights by shareholders who are not ordinarily resident in Hong Kong would be limited to not more than 49% of votes cast at a general meeting of shareholders.

14. Government to be empowered to obtain information from AA for the purpose of enforcing relevant laws and regulations.
15. AA would be required to submit capital investment plans to the Government as a regulator of the airport.
16. Government to be empowered to give directions to AA in the public interest, with compensation to AA under specified circumstances.
17. Government to be empowered to take over AA's assets in case of AA's default, with compensation to AA under specified circumstances.
18. Government to retain powers to revoke the aerodrome licence of AA in case of substantial breakdown of services at the airport or under other prescribed conditions.