

**For discussion  
On 2 March 2004**

**Legislative Council Panel on Economic Services**

**Response to Questions raised on 23 February 2004  
Relating to Privatization of the Airport Authority**

**Introduction**

At the meeting of the Panel held on 23 February 2004, Members considered LC Paper No. CB(1)1017/03-04(05) relating to privatization of the Airport Authority (AA). Members raised a number of questions on the proposed privatization and requested the Administration to provide responses for further discussion at a special meeting of the Panel on 2 March 2004. This paper provides the requested information.

**Overview**

2. In the past few months, the Administration has conducted informal consultation on the proposed privatization with many stakeholders to gauge their views on the matter. We are mindful of the concerns over certain issues relating to the proposed privatization, and therefore have decided to take more time to further consult stakeholders before putting a privatization bill to the Legislative Council. In the meantime, we intend to restructure the capital of AA in order to lower its overall costs of capital.

3. The proposed capital restructuring does not in anyway affect the ownership or corporate structure of AA. It does not preempt the arrangements for privatization, and indeed the decision on whether and when AA should be privatized. AA as a statutory corporation would still benefit from a lowering of its overall cost of capital. We propose to

restructure AA's capital as soon as possible so that AA could take advantage of the current low interest environment to raise debt financing.

4. We are providing below our responses to questions raised by Members at the meeting on 23 February 2004. We have grouped the questions into related subject areas to facilitate further discussion. On some of the issues raised by Members, the Administration intends to further consult stakeholders before coming to a view on the way forward. We are therefore unable to provide definitive answers to all questions raised, but we will endeavour to elaborate on our current thinking.

### **Specific Questions**

#### **A. Labour Issues**

- (i) *If the level of wages of staff working on the airport island is already very low now, would it be even lower after privatization?*
- (ii) *Employees of the airport franchisees and contractors are already suffering from low wages because AA uses the bidding price as the determining factor in contracting out its services. Employees are worried that situation will worsen after privatization. They also considered that it would affect the operation of the airport as well as its overall quality and standards of service.*
- (iii) *The paper should include an assessment on the impact of privatization on workers.*
- (iv) *How can the morale of employees and standards of service be maintained after privatization?*

5. At present, AA already has a very lean set-up with only about 900 staff. AA has confirmed that it has no plan to lay off any staff or reduce their benefits as a result of privatization.

6. As regards employees of airport franchisees and contractors, their employment and benefits should not be affected by the proposed privatization for several reasons.

7. First, AA is already operating under prudent commercial principles as required by Section 6 of the Airport Authority Ordinance (Cap. 483). This mode of operation would not change as a result of privatization.

8. Second, as a general principle, whenever AA seeks bids from the market for provision of services at the airport, the bidders' experience and service quality are the determining factors instead of pricing alone. Airport franchisees and contractors determine the wages and staffing level to ensure that the prescribed service standards are met. Again, this mode of operation would not change as a result of privatization.

9. Third, to ensure smooth and efficient operation of the airport, AA would continue to attach great importance to maintaining harmonious employee relations at the airport. We and AA are exploring the introduction of a reward and penalty system to link the actual service standards of AA to the level of airport charges to encourage good performance. This would help prevent AA from maximizing returns at the expense of service standards or staff quality.

10. Fourth, after privatization, issues relating to employment of labour would continue to be governed by relevant legislation that safeguard the interests of all employees.

11. Notwithstanding the above, we can appreciate the anxiety of staff working at the airport. AA has briefed its employees and the airport community on its privatization through various channels. It will continue to maintain effective communication with its staff and stakeholders. We will also continue to maintain a dialogue with them.

(v) *Does Government plan to conduct a study on the level of wages of employees at the airport island (covering past, present and post-privatization level of wages)?*

(vi) *Has the Government consulted the labour unions on the proposed privatization and what are their stances?*

12. Like other employees in Hong Kong, the wage level of employees of airport contractors and franchisees are determined primarily by the supply and demand in the labour market and the general state of the economy. As explained in the answers above, privatization of AA will not impact on the employment conditions at the airport. Any study on the wages of airport employees would only reflect the changes in the economy and labour market, and may not be relevant to the privatization exercise.

13. During our earlier consultations, we met with representatives of a number of unions, including the Staffs and Workers Unions of Hong Kong Civil Airlines which wrote to the Panel on 20 February, and solicited their initial views on the proposed privatization of AA. We have noted their concerns regarding possible impact of privatization on employees of airport contractors and franchisees. We will continue to engage them in taking forward the privatization exercise.

*(vii) What would be the impact of the proposed capital restructuring on AA's existing and future contracts with the franchisees? How would it affect the employees of the franchisees?*

14. The proposed capital restructuring involves optimizing the capital structure of AA and lowering its weighted average cost of capital. It is a widely accepted and frequently used financial arrangement which aims to enhance the value of AA in preparation for its eventual privatization. It would not affect AA's existing and future contracts with its contractors and franchisees or any of their operations. Therefore the proposed capital restructuring would have no impact on their employees.

## **B. Abuse of Monopolistic Power**

*(viii) AA owns more than 1 200 hectares of land on the airport island. What safeguards would be in place to prevent AA from abusing its monopolistic power after privatization?*

*(ix) AA should be given a free hand to run its retail business and control should only be imposed on businesses that display monopolistic characteristics.*

- (x) *AA is a natural monopoly, and such monopolistic characteristics also extend to other related businesses such as logistics and transport, etc. There is a need to formulate a workable regulatory mechanism.*

15. As a safeguard that AA would not take advantage of its position as a natural monopoly after privatization, we are studying the possibility of introducing certain statutory provisions in the privatization bill to prohibit AA from engaging in certain anti-competitive activities or abusing its dominant position. Reference will be made to similar provisions in the Telecommunications Ordinance (Cap. 106) and Broadcasting Ordinance (Cap. 562). In working out the details we will strike a balance between putting in place appropriate safeguards and allowing AA sufficient commercial flexibility to operate the airport in an efficient manner.

16. On land use at the airport, the existing land grant to AA contains stringent controls over land use on the airport island. Only airport operational, airport support, and airport related developments are permitted. While AA owns more than 1 200 hectares of land, over 90% of it has already been designated for the provision of airport operational facilities (such as runway, parking apron, and passenger terminals) and airport support facilities (such as air cargo handling, aircraft catering, and aircraft maintenance). Although AA can develop airport related facilities in the remaining land, it has to satisfy the Director of Lands that the development is in full compliance with the Master Layout Plan for the airport and obtain his approval for the relevant building plans. We intend to maintain the stringent controls under the land grant after privatization. These controls will ensure that AA will continue to focus on its core business of operating and developing the Hong Kong International Airport. For background information, the airport island covers some 1 200 hectares and was granted to AA in 1995 before the airport opened. Government has no plan to grant additional land to AA as a result of the proposed privatization.

- (xi) *Worry that AA would become an independent kingdom after privatization.*

17. Considering the importance of the airport to Hong Kong, Government is mindful of the need to retain suitable controls over AA after privatization. Apart from the competition related and land grant controls described above, we also intend to put in place a number of other regulatory controls over AA. For example, Government would be empowered to: (a) 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; (b) to obtain information from AA for the purpose of enforcing relevant laws and regulations; and (c) to give directions to AA in the public interest or take over AA's assets in case of AA's default, with compensation to AA under specified circumstances. Furthermore, Government will continue to retain all the powers under the Civil Aviation Ordinance (Cap. 448) and the Aviation Security Ordinance (Cap. 494) to ensure that AA would operate the airport in a safe and secure manner. LegCo can also continue to monitor the performance of AA through the Administration after privatization as it is currently the case.

### **C. Economic Regulation**

- (xii) *The existing high landing fees of the Hong Kong International Airport have driven away many airlines to the Macau airport and affect the economy of Hong Kong. Impact of privatizing AA on the economy as a whole should be carefully assessed.*
- (xiii) *Would AA just focus on maximizing returns to its shareholders after privatization?*
- (xiv) *Privatization of AA should bring benefits to all stakeholders as well as to the general public.*
- (xv) *Airport is a natural monopoly. How to balance interests of stakeholders in the regulation of airport charges, as well as other charges such as the security surcharge?*

18. Government's objective is to maintain the competitiveness of the Hong Kong International Airport and ensure that Hong Kong's status as a centre for international and regional aviation can be

maintained as required by the Basic Law. We are opposed to any unreasonable increase in airport charges purely for the sake of maximizing returns to AA's shareholders. Recognizing the monopolistic nature of aircraft landing and parking operations at the Hong Kong International Airport, we are now discussing with AA and airlines the regulatory arrangement for airport charges after privatization. The regulatory mechanism should adhere to the following principles: fair, "user pays"; predictable and stable; clear and transparent; allow reasonable return; provide incentives for efficiency, service quality and investment; and minimize administrative costs. Some possible features of the regulatory mechanism are set out in the Annex to LC Paper No. CB(1)1017/03-04(05). We have to further develop the details in consultation with the parties and stakeholders concerned and will further report to Members when ready. We would like to assure Members that Hong Kong's overall interests will always be at the forefront when formulating the regulatory mechanism.

*(xvi) Government would stay at arm's length after AA is privatized. Would this make AA less effective in its discussions and co-operation with regional airports, hence weakening the hub status of HKIA?*

19. At present, Government already has an arm's length relationship with AA so far as AA's commercial discussions and negotiations with third parties are concerned, including its discussions / negotiations with other airports. This does not have any adverse impact on AA's cooperation with other airports to strengthen the hub position of the Hong Kong International Airport as evident in AA's active role in discussing cooperative arrangements with airports in the Pearl River Delta. At the government level, we liaise with the relevant authorities in other places and offer our support from the perspective of advancing Hong Kong's overall interest. We will continue to do so after the privatization of AA.

*(xvii) Item 18 of Annex of LC Paper No. CB(1)1017/03-04(05) states that the aerodrome licence of AA might be revoked under specified circumstances. This means that the business of AA might be terminated. How would Government coordinate with the*

*Securities and Futures Commission in case of a revocation having regard to the listing requirements on the privatized AA?*

20. It is common for licences which are given to companies in Hong Kong or elsewhere including those whose shares are listed to be subject to a power of revocation. This seems to be generally accepted and expected. It is also an important safeguard to ensure performance to a satisfactory standard. Examples include companies providing transportation (buses, rail, ferry), telecommunications, broadcasting, financial services such as securities and futures, and banks. These are usually either listed companies or members of a listed group. Effective and reasonable regulatory control in these circumstances is expected to support the share price.

21. The statutory power to revoke the aerodrome licence of the AA has existed for many years. The statutory provisions are in line with experiences in other places. Similar provisions exist in other licensing regimes.

22. The power to revoke AA's aerodrome licence will not be used lightly and Government will contemplate its use only in exceptional circumstances such as substantial breakdown of services or material breaches of licence conditions. Even under these circumstances, the Government would need to first satisfy itself that other regulatory sanctions, such as the issue of directions requiring compliance or remedial performance and the imposition of financial penalties, have not been effective or are not appropriate.

23. The prospectus for AA's initial public offering would disclose details of the regulatory environment within which AA operates so as to ensure that prospective investors have a clear picture of the company before they invest. After the privatized AA is listed, it would be incumbent upon the company to fulfill any listing requirements, including the restrictions on disclosure of any price sensitive information.



## **D. Other Airport Privatization Experience**

*(xviii) Airports in North America are not privatized due to national security concerns. Would similar concerns arise if AA is to be privatized?*

24. Under the Aviation Security Ordinance (Cap 494), the Secretary for Security is the Aviation Security Authority who has wide powers to ensure that AA operates the airport in a safe and secure manner. Moreover, under the Air Navigation (Hong Kong) Order 1995 (Cap. 448 sub. leg. C), AA has to obtain an aerodrome licence from Director-General of Civil Aviation who in practice serves as the regulator of aviation safety and security at the Hong Kong International Airport. The statutory authorities on safety and security would be maintained after AA is privatized.

*(xix) The Government should provide more information on overseas airport privatization practices/experiences. Are other privatized airports comparable to the Hong Kong International Airport such as in terms of their profits?*

*(xx) The Government should provide more information on overseas airport privatization experiences (e.g. When were they privatized? What were their market capitalization and debt to equity ratio? How many times were they over-subscribed at the time of initial public offering? What were their profits post-privatization? What was the impact of privatization on employees?)*

25. In studying the privatization of AA, we have made reference to other airport privatization experiences. A summary of the information requested by Members is at the Annex.

## **E. Capital Restructuring**

*(xxi) Airlines in general support the capital restructuring proposal. However, they would like to know whether a larger amount should be returned to the Government.*

*(xxii) Is \$6 billion the right amount for AA to return to the Government?*

26. The objective of the proposed capital restructuring is to improve AA's capital efficiency, which will lower AA's overall cost of capital. In evaluating the amount of equity that AA should return to Government, we have sought to ensure that AA's financial position will not be undermined and its current credit rating can be maintained, and that it has the ability to raise further borrowings to finance essential capital expenditure in future. We consider a figure of about \$6 billion to be appropriate as this would result in a debt to equity ratio of about 1:2, giving AA the flexibility to satisfy its future investment requirements.

*(xxiii) AA should explain how it is going to fund the return of \$6 billion capital to the Government. Would it consider issuing retail bonds or would it just borrow from banks?*

27. In managing its finance, AA seeks to maintain well diversified and balanced sources of funding. It has borrowed from banks, and has accessed the debt capital markets through issuance of retail bonds and bonds targeted to institutional investors. To fund the return of capital to the Government, AA would endeavour to obtain the most cost effective financing having regard to the prevailing market conditions. It will closely monitor the market and may raise the required funding through one or a combination of the financing methods mentioned above.

*(xxiv) Support the 2-step approach in taking forward the privatization of AA.*

*(xxv) Support the return of \$6 billion to Government.*

*(xxvi) Support the capital restructuring proposal, regardless of when and how AA would be privatized.*

28. We thank Members for their support to the proposal.

## **F. Objectives of AA Privatization**

*(xxvii) What are the cons of privatizing the AA?*

*(xxviii) The paper should include the cons of privatizing AA instead of just listing the benefits.*

29. The Hong Kong International Airport is a strategic asset of Hong Kong. Its smooth and efficient operation has an important bearing on our economy. In taking forward the privatization exercise, one of our key considerations is to ensure that the privatized 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 indicated in the Annex to LC Paper No. CB(1)1017/03-04(05) a series of regulatory measures on the privatized AA, such as regulation of airport charges, representation of Government appointed directors on the AA Board, power of the Government to give directions to AA, etc. The objective is to strike a balance between protecting Hong Kong's overall interests and allowing suitable commercial flexibility for the company. We should also note that it is in the interest of the privatized AA to attract more traffic to the airport and ensure its smooth and efficient operations. The business interests of AA are therefore aligned with the overall interests of Hong Kong in this respect.

30. We have also listed in paragraph 12 of LC Paper No. CB(1)1017/03-04(05) a number of other specific concerns raised by stakeholders in the past few months. These include the possibility of AA abusing its monopolistic position and extracting undue benefits from its users, the need to monitor service standards and efficiency at the airport, and the risk of AA engaging in anti-competitive practices. These issues would also need to be properly addressed. Some possible options are listed in the Annex to LC Paper No. CB(1)1017/03-04(05).

*(xxix) The principle of "small government, big market" should be applied with caution. Government needs to consider all important issues thoroughly, and put in place necessary and appropriate measures.*

31. We generally agree with this comment. We will carefully consider all relevant issues and ensure that the overall public interest is safeguarded as we take forward the privatization exercise.

*(xxx) Please elaborate on how the airport can be more efficiently run after privatization as AA is already operating under prudent commercial principles, and on why AA needs to access the capital markets given that it can already borrow from the market.*

32. Although AA is already a corporation operating on prudent commercial principle, its listing on the Hong Kong Stock Exchange would subject the company to a greater degree of scrutiny by other investors, which would help derive even more efficiency. 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 the future in order to expand its business. A stock market listing provides access to such capital. Privatization via initial public offering would provide AA with added flexibility to ensure that it would have access to the necessary funds for financing projects essential for maintaining Hong Kong's aviation hub status.

*(xxxii) Privatization of airport is a worldwide trend and it has many merits. The board of AA would bear in mind the importance of maintaining the competitiveness of our airport as well as the impact which the airport would have on the entire economy in taking forward the privatization exercise.*

33. We agree with the comments.

## **G. Others**

*(xxxii) Need to consider the proper Chinese translation for the term "privatization"*

34. 我們曾考慮使用「私有化」作為“privatization”的中文名稱，但有鑑於「私有化」一詞在金融市場一般指由上市公司大股東回

購所有流通股份並取消上市地位，所以我們最終採用了「私營化」一詞。

*(xxxiii) Which company is serving as the Government's financial advisor?*

35. We have commissioned UBS Investment Bank as the Government's financial advisor in taking forward the privatization of AA.

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

### Examples of Airport Privatization– IPO Related Data

	<b>IPO date</b>	<b>Proceeds raised (US\$m)</b>	<b>Market cap at IPO (US\$m)</b>	<b>Oversubscription (x)</b>	<b>Net debt to equity ratio at time of IPO<sup>3</sup> (%)</b>
Auckland	July 1998	200	388	4.0	45
BAA <sup>1</sup>	July 1987	2,021	2,021	10.0	8
Beijing	February 2000	350	851	1.4	112
Copenhagen	April 1994	106	424	3.3	63
Fraport <sup>2</sup>	June 2001	796	2,948	8.5	118
Guangzhou	April 2003	277	1,628	Not available	Net cash
Vienna	June 1992	160	593	Not available	Net cash

Notes:

- 1 Operator of London's Heathrow, Gatwick and Stansted airports as well as a number of UK regional airports
- 2 Operator of the Frankfurt airports
- 3 Net debt to equity = Short term and long term borrowings minus cash and cash equivalents, divided by shareholders' equity. Where cash and cash equivalents are higher than total borrowings, the company is deemed to be in a "net cash" position

Source: IPO prospectuses, press and company reports

### Examples of Airport Privatization– Comparison with Hong Kong International Airport

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

Notes:

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

Source: Air Transport Intelligence, company reports

## Examples of Airport Privatization – Change in Number of Employees Post-privatization

### Number of employees <sup>1</sup>

<b>Company</b>	<b>Year of privatization</b>	<b>Year -1</b>	<b>Year 0<sup>2</sup></b>	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>
Auckland	1998	249	260	268	269	282
BAA	1987	7,216	7,462	7,569	7,936	8,435
Copenhagen	1994	1,204	1,170	1,213	1,314	1,356
Fraport	2001	6,904	7,951	15,195 <sup>3</sup>	--	--
Vienna	1992	905	967	1,009	1,055	1,119

Notes:

1 Excludes ground handling

2 Year 0 is the privatization year

3 Increase mainly as a result of acquisition

Source: Company reports



## Examples of Airport Privatization –Change in EBITDA<sup>1</sup> Post-privatization

### EBITDA

Local currency (m)	Year -1	Year 0 <sup>2</sup>	Year 1	Year 2	Year 3
Auckland	98	107	113	124	139
BAA	163	177	210	252	295
Copenhagen	465	522	660	753	847
Fraport	469	491	481	--	--
Vienna	748	962	893	1,177	1,380

### EBITDA

HK\$m <sup>3</sup>	Year -1	Year 0 <sup>2</sup>	Year 1	Year 2	Year 3
Auckland	527	576	608	667	748
BAA	2,399	2,605	3,091	3,709	4,342
Copenhagen	614	689	871	994	1,118
Fraport	4,629	4,846	4,747	--	--
Vienna	539	693	643	847	994

Notes:

- 1 Earnings before interest tax depreciation and amortisation
- 2 Year 0 is the privatization year
- 3 Using the following fixed exchange rates:
  - GBP/HK\$: 14.72      ATS/HK\$: 0.72      DKK/HK\$: 1.32
  - NZ\$/HK\$: 5.38      €/HK\$: 9.87

Source : Company reports