

For information

Legislative Council Panel on Economic Services

**Response to Questions raised on 2 March 2004
Relating to Privatization of the Airport Authority**

Introduction

At the meeting of the Panel held on 2 March 2004, Members considered LC Papers No. CB(1)1017/03-04(05) and No. CB(1)1154/03-04(01) relating to privatization of the Airport Authority (AA). The Administration agreed to provide written response to questions raised by Members. The requested information is set out below.

Response to Questions

(i) *Can the Government take back the land on the airport island not already earmarked for airport operational and support facilities before privatizing AA?*

2. The airport island measures about 1 255 hectares and its size is relatively modest compared to many other international airports such as Singapore's Changi (1 600 hectares), the new Bangkok Airport (3 200 hectares), Seoul's Incheon (5 600 hectares) and Kuala Lumpur's Sepang (10 000 hectares). As we pointed out in LC Paper No. CB(1)1154/03-04(01), the vast majority of the land on the airport island has already been designated for the provision of airport operational and airport support facilities. All the remaining 7.1% of the airport island, or 89 hectares, is earmarked for other "airport-related" development. And of this area, 40.4 hectares have already been developed and AA also has to reserve suitable sites from the remaining area for future expansion of freight processing facilities and additional airport hotels. Therefore, the uncommitted area that could be open for other airport-related uses is very limited.

3. AA is a statutory body set up under the law to be responsible for the running and development of the Hong Kong International Airport. The whole airport island was granted to AA in 1995 under a legally binding land lease.

AA is a financially autonomous body and has the legal responsibility to operate under prudent commercial principles to fulfill its responsibility mentioned above. In discharging its responsibility under the law, AA should have the power to make use of its land on airport-related uses so as to plan and develop facilities that are necessary in support of airport operations. Taking back part of the land on the airport island would constrain AA's ability to respond to the rapidly changing needs of the aviation business and develop holistic plans for the future expansion of our airport.

4. As explained in LC Paper No. CB(1)1154/03-04(01), the existing land grant to AA contains stringent controls over land uses on the airport island. Before AA can develop any "airport-related" facilities, 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 the latter's approval for the relevant building plans. These stringent controls should have provided sufficient safeguards against any abuses.

(ii) *Given the nature of the airport business, it would not be practicable to introduce any competition in this sector in Hong Kong. What other legislation would the Administration make reference to in drawing up the competition-related provisions in the privatization bill apart from the Telecommunications Ordinance and Broadcasting Ordinance?*

5. AA enjoys a natural monopoly in aircraft landing and parking operations at the Hong Kong International Airport. For these activities, we intend to devise a form of regulatory mechanism to govern the setting of airport charges by AA. In response to concerns expressed during the informal consultation undertaken by the Government, we are examining the merits of including some competition-related provisions in the privatization bill to complement this regulatory mechanism. This would represent an additional level of safeguard to ensure that AA would not abuse its market power in areas other than aircraft landing and parking.

6. Apart from the Telecommunications Ordinance and Broadcasting Ordinance, we will also make reference to relevant legislation overseas, such as that in Europe and Australia.

(iii) *Would the Administration conduct a study on the level of wages at the airport before and after the relocation of the airport from Kai Tak to Chek Lap Kok?*

7. Given the lapse of time, it is not practicable to conduct any study on the level of wages at the airport before and after the relocation of the airport

from Kai Tak to Chek Lap Kok. It will be very difficult to correlate the changes in wage levels with either the relocation of the airport or the future privatization. This is because wage is affected by many factors, such as changes in the employment structure of the sampled companies, the labour market and the general state of economy of Hong Kong, and may not be relevant to the relocation or the privatization exercise.

8. However, it is the intention of the AA that its contractors should pay their employees reasonable wages to ensure that quality services are provided at the airport. AA will keep in view the wage trend of airport workers, especially when new contracts are awarded in future.

(iv) *The Administration to provide additional information on privatization experience elsewhere, including the contributing factors for growth in EBITDA, the dividend rate, p/e ratio, operating profit after tax, target investors at the time of IPO as well as the land use arrangements in respect of the relevant airports.*

Annexes A to C

9. The requested information is set out in Annexes A to C attached.

(v) *The Administration to provide more detailed analysis on the pros and cons of various privatization and capital restructuring options.*

Annex D

10. The pros and cons of the privatization options we have studied are set out in Annex D. As regards capital restructuring, we are not aware of any other viable option for achieving the objective apart from the arrangement currently proposed.

(vi) *Is it possible to remove the compensation clause in the Government's power to give directions to AA in the public interest?*

11. Under the existing provisions of the AA Ordinance, compensation is payable to AA under specified circumstances if directions are issued by the Government in the public interest. This provides comfort to AA and its creditors that AA would operate in accordance with prudent commercial principles as stipulated under the Ordinance, and that AA would be compensated in case it is unable to do so as a result of complying with the Government's directions.

12. It is worth noting that the MTR Ordinance also provides that in giving direction to MTR Corporation Limited in the public interest, Government is liable to paying compensation to the company under specified circumstances. The financial advisors of both the Government and AA have advised that if the

compensation clause is removed from the privatization bill, potential investors would view that as a retrograde step and that it would likely affect AA's credit ratings, and hence its capital raising ability, and undermine the valuation of AA on IPO.

Economic Development and Labour Bureau
May 2004

Traffic Throughput, Revenue, Earnings and Dividend of Some Privatized Airports

(I) Traffic Throughput

Year	-1	0 ⁽¹⁾	1	2	3	CAGR ⁽²⁾
Passengers (million)						
Auckland International Airport	7.6	7.5	7.7	8.0	8.4	2.6%
BAA plc	53.4	55.3	63.7	68.0	71.3	7.5%
Copenhagen Airports	12.9	14.1	15.0	16.1	17.1	7.3%
Fraport AG ⁽³⁾	49.4	48.6	48.5	-	-	-0.9%
Vienna International Airport	5.8	6.8	7.2	7.7	8.5	9.8%
Cargo ('000 tonnes)						
Auckland International Airport	189.9	193.5	186.3	191.7	187.0	-0.4%
BAA plc	835.0	864.0	952.0	1,021.0	1,090.0	6.9%
Copenhagen Airports	243.5	273.5	309.8	338.0	387.7	12.3%
Fraport AG	1,730.4	1,635.2	1,656.0	-	-	-2.2%
Vienna International Airport	86.1	94.5	99.5	113.9	125.8	9.9%
WLU⁽⁴⁾ (million)						
Auckland International Airport	9.5	9.4	9.5	9.9	10.3	2.1%
BAA plc	61.8	63.9	73.2	78.2	82.2	7.4%
Copenhagen Airports	15.3	16.8	18.1	19.5	20.9	8.1%
Fraport AG	66.7	65.0	65.1	-	-	-1.2%
Vienna International Airport	6.7	7.7	8.2	8.8	9.8	9.8%

Source: Company reports

Notes:

(1) Year 0 is the privatization year.

(2) Compound annual growth rate.

(3) Information on Fraport AG available for one year only post-privatization as the company was privatized in 2001.

(4) 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.

(II) Revenue

Year	-1	0⁽¹⁾	1	2	3	CAGR⁽²⁾
Aeronautical revenue⁽³⁾ (million)						
Auckland International Airport (NZ\$)	78	80	83	85	97	5.4%
BAA plc (£)	198	212	228	- ⁽⁵⁾	- ⁽⁵⁾	7.3% ⁽⁶⁾
Copenhagen Airports (DKK)	590	625	662	712	757	6.5%
Frapport AG (€)	618	656	879	-	-	19.3%
Vienna International Airport ⁽⁴⁾ (ATS)	1,774	2,081	2,233	2,318	2,686	10.9%
Non-aeronautical revenue⁽³⁾ (million)						
Auckland International Airport (NZ\$)	42	50	56	63	68	13.1%
BAA plc (£)	134	158	282	- ⁽⁵⁾	- ⁽⁵⁾	45.0% ⁽⁶⁾
Copenhagen Airports (DKK)	285	302	416	543	597	20.3%
Frapport AG (€)	391	469	429	-	-	4.7%
Vienna International Airport (ATS)	684	798	862	1,024	1,105	12.8%
Other revenue⁽⁷⁾ (million)						
Auckland International Airport (NZ\$)	20	25	21	22	25	5.1%
BAA plc (£)	64	69	13	44	62	-0.8%
Copenhagen Airports (DKK)	101	100	123	140	145	9.5%
Frapport AG (€)	612	589	594	-	-	-1.4%
Vienna International Airport (ATS)	0	0	0	0	0	not applicable

Year	-1	0⁽¹⁾	1	2	3	CAGR⁽²⁾
Total revenue (million)						
Auckland International Airport (NZ\$)	140	155	160	170	189	7.8%
BAA plc (£)	396	439	523	641	747	17.2%
Copenhagen Airports (DKK)	976	1,027	1,201	1,395	1,499	11.3%
Fraport AG (€)	1,621	1,714	1,902	-	-	8.3%
Vienna International Airport (ATS)	2,458	2,879	3,096	3,342	3,791	11.4%

Source: Company reports

Notes:

- (1) Year 0 is the privatization year.
- (2) Compound annual growth rate.
- (3) Definitions for aeronautical and non-aeronautical revenues may vary among airports.
- (4) Vienna International Airport includes ground handling activities in the “aviation” segment. No split is provided by the company.
- (5) Split of aeronautical and non-aeronautical revenues for year 2 and 3 of BAA plc is not available. The sum of aeronautical and non-aeronautical revenues is £597 million in Year 2 and £685 million in Year 3.
- (6) CAGR from Year -1 to Year 1 only.
- (7) Items included under other revenues:
 - Auckland International Airport: rental income and utilities
 - BAA plc: rental income (rents derived from leases of property and land for a wide variety of purposes associated with airport operations, and revenues from the provision of certain services to tenants under these leases and tenancy agreements)
 - Copenhagen Airports: rental income (rent from letting of premises and land and sale of services, including security services, bus transport, etc.)
 - Fraport AG: ground handling activities and other activities in support of the airport operations (such as information and communication services, electric power supply, canteen facilities, etc.)

(III) Earnings and Dividend

Year	-1	0⁽¹⁾	1	2	3	CAGR⁽²⁾
EBITDA⁽³⁾ (million)						
Auckland International Airport (NZ\$)	98	107	113	124	139	9.2%
BAA plc (£)	163	177	210	252	295	16.0%
Copenhagen Airports (DKK)	465	522	660	753	847	16.2%
Frapport AG (€)	469	491	481	-	-	1.3%
Vienna International Airport (ATS)	748	962	893	1,177	1,380	16.5%
Net income⁽⁴⁾ (million)						
Auckland International Airport (NZ\$)	41	41	42	51	59	9.9%
BAA plc (£)	40	34	61	113	166	42.6%
Copenhagen Airports (DKK)	144	180	247	279	323	22.4%
Frapport AG (€)	129	139	107	-	-	-9.1%
Vienna International Airport (ATS)	344	527	534	557	673	18.2%
Dividend declared (million)						
Auckland International Airport (NZ\$)	24	146	34	64	47	18.2%
BAA plc (£)	0	0	36	45	58	not applicable
Copenhagen Airports (DKK)	54	54	63	68	72	7.6%
Frapport AG (€)	77	36	0	-	-	-100.0%
Vienna International Airport (ATS)	50	160	160	201	252	50.2%

Year	-1	0⁽¹⁾	1	2	3	CAGR⁽²⁾
Dividend payout ratio						
Auckland International Airport	60%	355%	79%	125%	80%	not applicable
BAA plc	0%	0%	59%	40%	35%	not applicable
Copenhagen Airports	38%	30%	25%	24%	22%	not applicable
Fraport AG	59%	26%	0%	-	-	not applicable
Vienna International Airport	14%	30%	30%	36%	37%	not applicable

Source: Company reports

Notes:

- (1) Year 0 is the privatization year.
- (2) Compound annual growth rate.
- (3) Earnings before interest, tax, depreciation and amortization.
- (4) Earnings after interest, tax depreciation and amortization.

**Target Investors at the Time of IPO and Price Earnings Ratio
of Some Privatized Airports**

	Retail⁽¹⁾	Institutional⁽²⁾	Price/Earnings Ratio at IPO⁽³⁾
Auckland International Airport	42%	58%	12.9
BAA plc	77%	23%	16.2
Copenhagen Airports	20%	80%	18.0
Fraport AG	40%	60%	15.5
Vienna International Airport	not available	not available	12.0

Source: Finance publications and press reports.

Notes:

(1) Percentage of shares offered to retail investors.

(2) Percentage of shares offered to institutional investors.

(3) Price of a stock at the time of IPO divided by its reported earnings from the latest year.

Land Use Arrangements for Some Privatized Airports

Airport company	Ownership		Type of ownership	Remarks
	Land	Assets		
Auckland International Airport	Company	Company	Freehold	◆ The construction of new facilities (in particular new runways) are subject to planning permission by the New Zealand Government.
BAA plc	Company	Company	Freehold	◆ BAA PLC plc owns the land and assets of its UK airports. However, any significant development (e.g. terminal, runways) is subject to a set of planning procedures and approval by the Civil Aviation Authority.
Copenhagen Airports	Company	Company	Freehold	◆ Copenhagen Airports owns the land, the buildings and other related assets (e.g. car parks) of the airports at Karstrup and Roksilde. In addition, the company owns a number of small areas outside the airport area at Kastrup, which have been rented out mainly to Scandinavian Air System.
Fraport AG	Company	Company	Freehold	<p>◆ Fraport AG owns the land on which Frankfurt Airport is operated and most of the airport's buildings and business facilities.</p> <p>◆ Fraport AG has granted leases to third parties for a number of construction projects such as the InterCity Express railway station, hotel buildings and other buildings integrated with Frankfurt Airport.</p>

Airport company	Ownership		Type of ownership	Remarks
	Land	Assets		
Vienna International Airport	Company	Company	Freehold	◆ Until 1994, Vienna International Airport International Airport had a long lease on the land that the airport was built on for purposes related to airport operations. The company acquired the land from the Austrian Government in freehold terms prior to its secondary sale in 1995.
Sydney Airport Corporation Ltd	Company	Company	Leasehold	◆ Sydney Airports Corporation Limited ("SACL") leases the airport land plus the assets site from the Australian Government under a 50 year lease which commenced on 1 July 1998, with an option to renew the lease for a further 49 years after its expiry.

Source: Company reports

Salient Features of Privatization Options Considered and their Pros and Cons

(I) IPO

Key features

- ◆ Government launches an initial public offering for AA on the Stock Exchange of Hong Kong
- ◆ Government disposes of part of its shares in AA for purchase by domestic and international investors

Pros

- ◆ Familiar to Hong Kong people
- ◆ Allow participation by the people of Hong Kong in a strategic infrastructure
- ◆ Flexibility to retain a residual stake in AA or to conduct subsequent sale in stages
- ◆ Enhance public awareness and heighten international profile of AA and HKIA
- ◆ Enhance management accountability and focus and increase AA's financial flexibility
- ◆ Increase breadth and depth of the local stock market

Cons

- ◆ Success hinges on the prevailing market conditions and investor sentiment

(II) Sale to Strategic Investors

Key features

- ◆ The Government sells a minority stake in AA to a strategic buyer
- ◆ Government and the strategic buyer share ownership of AA

Pros

- ◆ Enhance AA's strategic positioning via possible shared management expertise, heightened international presence and signal of support and confidence from a leading industry player
- ◆ Potential to achieve a higher price than a pure IPO, particularly if the Government concedes control
- ◆ Flexibility for the Government to IPO the remaining stake at a later date
- ◆ The sale process is less dependent on equity market conditions

Cons

- ◆ Very limited universe of logical trade buyers with the necessary commercial freedom, strategic fit and funding capacity
- ◆ The large size of the AA asset further limits the universe of potential trade buyers
- ◆ The highly concentrated ownership would enable the strategic buyer to exert control on AA which might be undesirable given its strategic nature
- ◆ Need to devise a workable and acceptable process for selecting buyer
- ◆ Determination of fair market value extremely difficult

(III) Securitisation

Key features

- ◆ Securitisation involves the sale of assets with a regular cash flow stream to a separate special purpose vehicle (“SPV”), which in turn issues securities backed by the credit-enhanced and repackaged cash flows to fund the purchase of the assets from AA. The SPV must be isolated from the credit risk of AA to ensure an independent, more favourable credit rating on the issued securities, thereby utilising a capital markets tool that effectively lowers the cost of funding.

Pros

- ◆ Allow Government to monetise AA’s cash flows without selling an equity stake
- ◆ Potentially enhance Hong Kong’s status as a pioneer in financial engineering

Cons

- ◆ No change in Government ownership – not strictly privatization
- ◆ Cannot capture the full equity value of AA
- ◆ Limited benefits given the already strong credit rating of AA

(IV) Going Public Exchangeable Bond

Key features

- ◆ A going public exchangeable bond allows Government to raise funds ahead of the actual IPO of AA. Going public bonds are fixed income instruments with two possible outcomes:
 - redemption into shares or convertible bonds at the time of the subsequent IPO; or
 - redemption for cash if the envisaged IPO does not occur

Pros

- ◆ Allow Government to derive capital revenue prior to IPO
- ◆ Signal commitment to IPO process and timetable

Cons

- ◆ Size of going public bond is usually limited by the percentage intended for free float at IPO (typically 25–30%)
- ◆ Issue size has to be carefully considered versus expected free float at IPO to mitigate future arbitrage
- ◆ Complicated structure and hence discourage participation by Hong Kong retail investors
- ◆ Few quality precedents in Hong Kong

(V) Sale to Exchange Fund

Key features

- ◆ Stage 1: Government sells part or all of its shares in AA to the Exchange Fund
- ◆ Stage 2: The Exchange Fund can keep the AA stake with a view to listing it when conditions are favourable and valuation potentially higher

Pros

- ◆ Generate capital revenue to the Government in the short term
- ◆ Limited impact on key stakeholders unless the Exchange Fund chooses to monetise its stake at a later stage as is envisaged in Stage 2

Cons

- ◆ Unlikely to obtain premium valuation for AA
- ◆ Not strictly privatization as long as the Exchange Fund holds onto its stake in AA
- ◆ Additional step to AA's eventual privatisation, leading to higher transaction costs and more work in aggregate