Malaysian Aviation Commission
Suruhanjaya Penerbangan Malaysia
MAVCOM

INTRODUCTION

This 2019 Budget Commentary is intended to provide the Malaysian Aviation Commission's ("**MAVCOM**" or "**Commission**") initial views on two planned Budget 2019 initiatives announced by the Government of Malaysia ("**GoM**") on Friday, 2 November 2018 related to the aviation industry, namely a proposed Airport Real Estate Investment Trust ("**Airport REIT**") and a proposed departure levy for all international outbound travellers by air commencing on 1 June 2019 ("**Departure Levy**").

PROPOSED AIRPORT REIT

The GoM, being the asset owner of almost all commercial airports in Malaysia, stated in the Budget 2019 announcement that:

- it intends to set up the world's first Airport REIT, with a target of raising RM4 billion by selling a 30% stake in the REIT to private investment institutions;

- investors of the Airport REIT will receive returns derived from user fee payments paid by Malaysia Airports Holdings Berhad ("**MAHB**")—the operator of thirty-nine (39) commercial airports in Malaysia—to the GoM;

- the Airport REIT exercise will only be carried out after the Aeronautical Charges Framework / Regulated Asset Base framework ("**RAB Framework**") currently being established by MAVCOM and the user fee structure under a renegotiated Operating Agreement between the GoM and MAHB ("**Operating Agreement**") have been finalised; and

- the Airport REIT will later raise funds publicly and the proceeds raised by the GoM from the Airport REIT will go towards funding future airport developments, and thereby maintain MAHB as an asset light airport operator.

A Consultation Paper on the Aeronautical Charges Framework / RAB Framework which was published on 19 October 2018 is available on MAVCOM's website (please see Consultation Paper on Aeronautical Charges Framework).

As details of the proposal are scarce, there is difficulty in precisely determining how the proposed Airport REIT could be of benefit to the airports industry in Malaysia. MAVCOM's initial thoughts on the potential impact of the proposed Airport REIT on the airports industry in Malaysia based on available information are nevertheless laid out below:

Economics of airport operatorship to be determined beforehand – the GoM's commitment to only embark on the proposed Airport REIT after the RAB Framework and Operating Agreement renegotiation have been concluded is commendable and appropriate as the economic details of the airport operatorship should be ascertained beforehand. The RAB Framework and the Operating Agreement renegotiation, which essentially determine the economics of MAHB and thirty-nine (39) of Malaysia's forty-two (42) commercial airports, are being drawn to facilitate long-term benefits for the industry and consumers, and therefore should not be subjected to any risk of potential distortion arising from the development of the proposed Airport REIT (such as those highlighted below).

The need for cross-subsidisation within the airport network – historically, loss-making airports in MAHB's airports portfolio have been cross-subsidised by the profitable airports. Those airports which are loss-making are typically those which handle passenger traffic of less than 2 million passengers per annum and handle primarily domestic traffic – these include those airports located in Ipoh, Melaka, Kuala Terengganu, Kuantan, Bintulu, Sandakan and the short take-off and landing ("**STOL**") airports. The existing cross-subsidy arrangement has been rendered necessary to ensure such airports continue to operate and serve the localities concerned. Unless the GoM decides otherwise, MAVCOM expects that this cross-subsidisation arrangement will continue even after the establishment of the RAB Framework.

With an Airport REIT in place, the cash flows at MAHB or the airport operator level need to be adequately unrestricted to allow the continuation of cross-subsidisation within the airport network.

Ownership of airport lands – one of the key issues that remain before the airports are injected into the Airport REIT is the complexity regarding the ownership of land on which these airports are located. While most of the land belongs directly to, or are leased to the Federal Land Commission, some airports sit on land with multiple ownership structures, between Federal and State governments and agencies, and even private ownership. This is potentially an operational issue requiring resolution prior to inclusion of any airport asset into the proposed Airport REIT.

Airport charges being linked to Airport REIT yields – information on how the Airport REIT's valuation has been derived is currently unavailable. However, as stated above, its yields are to be derived from user fees payable by MAHB out of all thirty-nine (39) airports.

As airport aeronautical revenues form a substantial portion of MAHB's Malaysian operations revenues (43.1% as of September 2018), the Airport REIT yields and attractiveness to potential investors would therefore be linked to the level of airport charges of those airport under the Airport REIT.

Airport users, including passengers and airlines, will therefore need to be cautious of the possible risk of airport charges being subjected to an artificial upward pressure by the Airport REIT's yield requirements, as opposed to being calculated based on airports' operations, capital expenditure considerations, user requirements, and service levels.

Efficiency of future airport capital planning process – a key underlying objective of the RAB Framework, in line with the direction of on-going discussions for a renegotiated Operating Agreement, is that the responsibilities for airport capital expenditures and funding of those expenditures reside primarily with the airport operator.

This is a departure from the arrangement under the existing Operating Agreement, whereby the GoM is the default party responsible for providing funds for any airport development expenditure that is intended to increase the passenger handling capacity of an airport.

The arrangement where the airport operator is responsible for airport developments and its funding is aligned with global practices and typically results in a more efficient, disciplined and cost-conscious airport capital planning approach, and airports designed in accordance with commercial and industry needs.

The GoM's proceeds arising from the Airport REIT could be used to fund or subsidise MAHB's capital expenditure requirements for future airport developments as stated in the Budget 2019 announcement but could undermine the long-term capital planning process improvements being pursued by the RAB Framework and the new Operating Agreement currently under renegotiation.

Lack of clarity on the utilisation of the initial RM4 billion proceeds of the Airport REIT – the GoM plans for the Airport REIT to raise funds publicly from issuances of new Airport REIT units and borrowings and to utilise those proceeds to fund future airport development. Whether the initial RM4 billion to be raised from the GoM will similarly be utilised to fund airport developments, however, is unclear.

As of November 2018, eight (8) of the thirty-nine (39) airports managed by MAHB are operating above their terminal theoretical design capacity. Future capital expenditure requirements for Malaysia's airports are presently being estimated by MAHB and will be subjected to an appropriate challenge process under the RAB Framework.

As such, determining the adequacy of the initial RM4 billion and any subsequent GoM's cash proceeds relative to Malaysia's future airport capital expenditure requirements is likely to be premature at this stage.

Cost of financing for the GoM – MAVCOM notes that yield expectations of REIT investors typically are in the 4.5 – 8.4% range[1], which means the Airport REIT could be a costlier source of funding for the GoM in comparison to other modes of financing such as Malaysian Government Securities ("**MGS**") which attract interest rates of approximately 3.85% (as at 16 November 2018).

More details on the Airport REIT necessary for a comprehensive evaluation – in order to facilitate a more complete evaluation of the Airport REIT and its impact on the Malaysian airports industry, additional details such as transaction structure, assets for inclusion in the Airport REIT, cashflows, encumbrances, and timing are necessary. MAVCOM will look to provide further commentary when such details are available.

[1] ThomsonReuters, as at 16 November 2018

PROPOSED DEPARTURE LEVY

The GoM is planning to impose a Departure Levy for all outbound international air travellers starting from 1 June 2019, with the stated objective of encouraging domestic travel. The levy rates are two-tiered at RM20 and RM40 on air travellers flying to ASEAN countries and to non-ASEAN countries respectively. The concept could be similar to levies at other countries such as such as the Air Passenger Departure Tax in Hong Kong SAR (~USD15 per departing passenger), and Departure Tax in Japan (~USD9 per departing passenger). In the United Kingdom, the Air Passenger Duty ("**APD**") is categorised by Band A and Band B, which are differentiated by class of travel and by distance.

Potential inconsistency with ICAO guidelines and international good practices – the Departure Levy, under its announced structure, is estimated to generate proceeds of approximately RM750 million per annum based on current departing passenger figures for ASEAN and international destinations beyond ASEAN. The GoM, via a statement on 12 November by the Ministry of Transport, indicated that the Departure Levy is a form of taxation that is intended to raise revenue for the GoM.

This is distinct from airport charges such as the PSC which generate revenues for the airport operator and serve to fund the cost of airport operations.

In summary, the International Civil Aviation Organisation's ("**ICAO**") Policy on Taxation (Doc 8632-C/968) and Policy on Charges for Airports and Air Navigation Services (Doc 9082) state that any cost imposed on the air traveller should be utilised for the benefit of the aviation industry and any collection without the intention to recover the costs of providing facilities and services for the civil aviation sector, is considered as a form of tax. Furthermore, ICAO is against the imposition of such taxes on air travellers especially when such taxes are absent from other modes of travel such as road or rail transport.

Whether the proceeds generated by the Departure Levy will be utilised for aviation purposes, and whether the Departure Levy will also be imposed on other modes of transport, are presently unclear.

Should, however, the proceeds of the Departure Levy not ploughed back into the industry and a similar tax is not imposed on other modes of transport, the GoM risks contravening the ICAO guidelines on this subject. While these ICAO guidelines are not obligatory on a Member State, non-compliance with these guidelines arising from the Departure Levy will move Malaysia away from international good practices in the aviation industry.

The Departure Levy will also be inconsistent in spirit to other efforts currently taken by the GoM and MAVCOM to bring policy-making, administrative, and regulatory practices in the Malaysian aviation industry closer to international standards.

Increase in cost to consumers – the Departure Levy will increase non-airfare costs to passengers in Malaysia by 57.1% and 54.8% for outbound travellers to ASEAN and beyond ASEAN, respectively. This is in comparison to the current PSC of RM35 per passenger to ASEAN countries and RM73 per passenger to destinations beyond ASEAN as well as the Regulatory Service Charge ("**RSC**") of RM1 per passenger.

This is a material increase and will render Malaysia becoming a destination that is no longer amongst the lowest regionally or globally in terms of non-airfare costs. Whether this will affect the competitiveness of Malaysian airports compared to other regional hubs and indeed dissuades international travel by Malaysians in favour of domestic travel as intended by the GoM remain to be seen.

The comparisons of airport charges globally and regionally are shown in the Appendix.

Discipline required to avoid potential increases in Departure Levy – the United Kingdom charges an APD, which is similarly imposed on departing passengers (both domestic and international) and the proceeds for which are channelled to the UK Government's coffers instead of being ring-fenced for reinvestment into its aviation industry.

MAVCOM notes that the APD currently imposed on departing passengers of GBP450, which is the highest rate in Band B, is 10.3 times higher than the initial APD introduced in 1994 of GBP40, which was the highest rate charged. The GoM therefore will need to institute discipline in the face of its present fiscal challenges to retain the Departure Levy at absolute maximum at its proposed introductory rates, to avoid consumers in Malaysia from being charged higher amounts in the future and render Malaysia as a costlier place to fly from.

Basis of Departure Levy rates are not presently known – once the RAB Framework has been deployed in mid-2019, airport charges in Malaysia would have been calculated based on quantifiable assumptions that have been subjected to discussion and challenge amongst industry stakeholders. As such, a considerable effort is being made to ensure that consumers in Malaysia pay airport charges that are set in a transparent manner and at a level that is commensurate with what is required to fund the airports industry in Malaysia. The method of setting the Departure Levy rates, however, is presently not known.

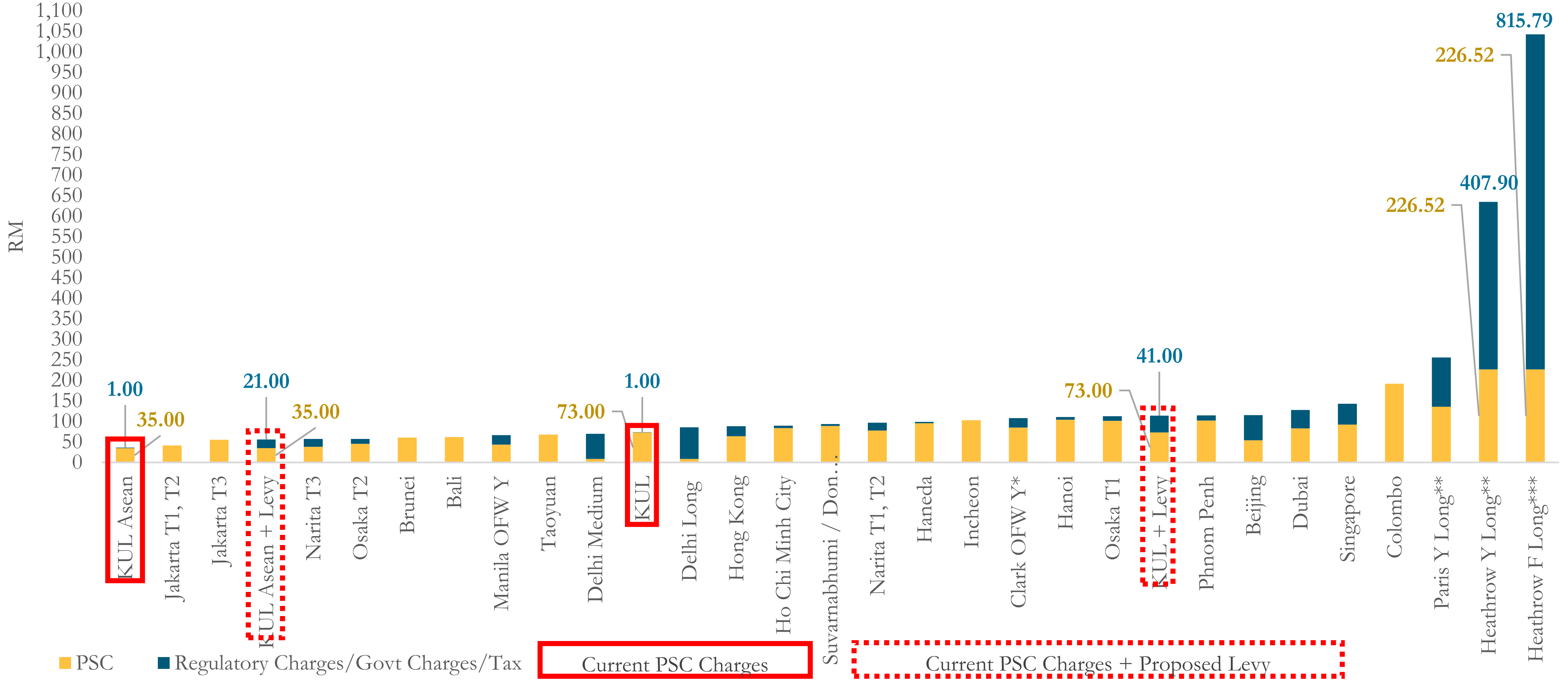
Stakeholders to consider implications on cost arising from Departure Levy under the RAB Framework – costs to consumers will be amongst the key factors to be taken into account when determining levels of airport charges under the RAB Framework. MAVCOM and other industry stakeholders including MAHB and the GoM will need to consider the Departure Levy and its consequent increase in cost to consumers when debating appropriate future levels of capital expenditure in the airports industry and their resultant service levels and airport charges.

CONCLUSION

The GoM has Malaysia's overall fiscal circumstances to consider in introducing any measure under the Budget 2019, including the proposed Airport REIT and the proposed Departure Levy. Excluding the GoM's wider fiscal considerations and in the absence of additional information on both proposals, it is difficult to determine the benefits that the proposed Airport REIT and proposed Departure Levy could bring to the aviation industry. If not carefully designed, the two proposals could, however, materially constrain MAVCOM's RAB Framework development and the Operating Agreement renegotiation work tracks which seek to resolve *inter alia* issues surrounding airport development funding, industry investment, airport planning, capital expenditure discipline, and quality of services.

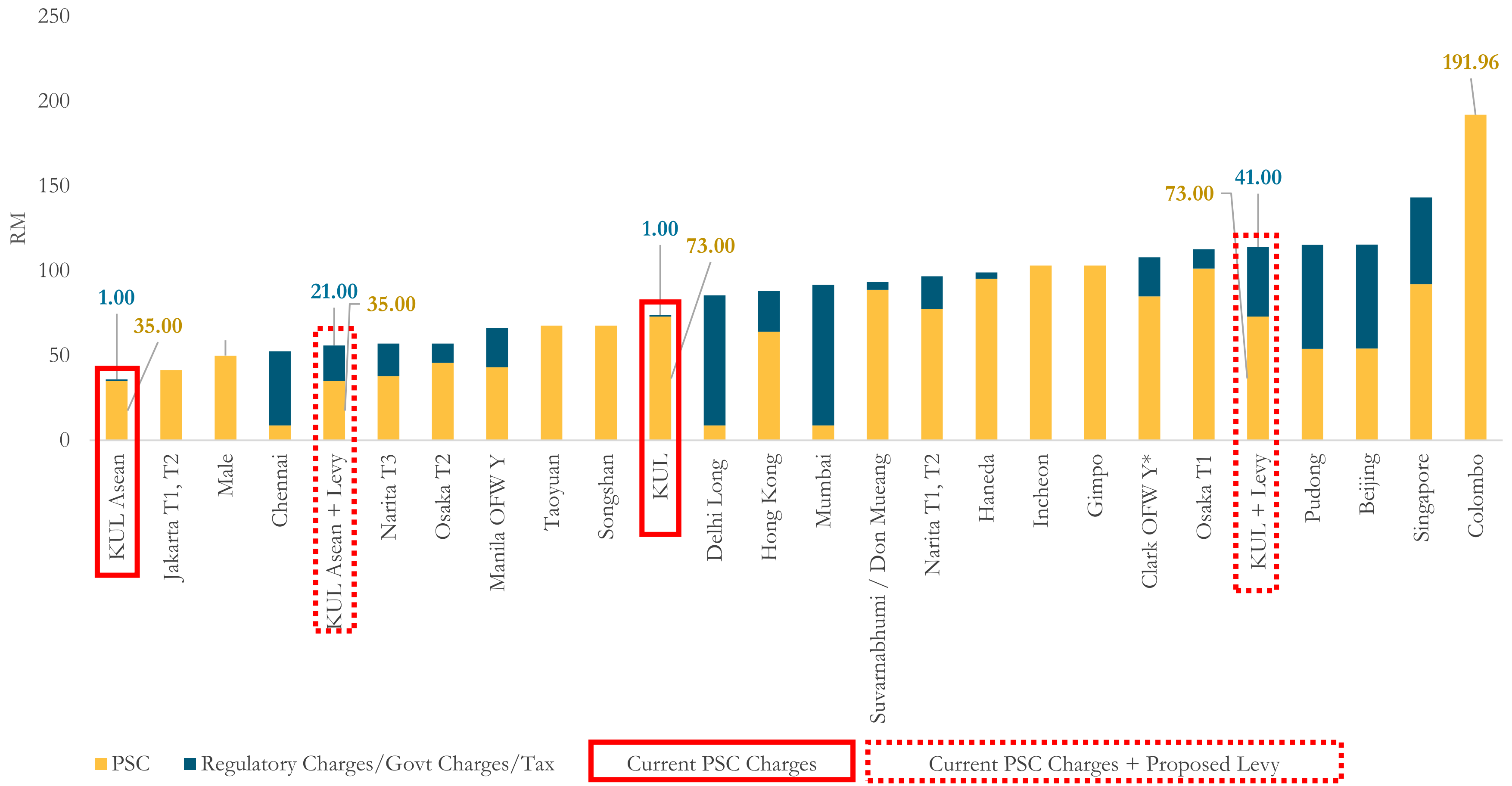
Appendix

Figure 1: Comparison of Airport Charges Globally



Source: MAVCOM Analysis, as at 1 November 2018
Government charges and taxes are additional charges paid to the government authorities of the respective countries
**OFW Y refers to Overseas Filipino Worker flying Economy class*
***Y Long refers to Long-haul Economy class flight*
****F Long refers to long-haul Business class flight*

Figure 2: Comparison of Airport Charges Regionally



Source: MAVCOM Analysis, as at 1 November 2018
Government charges and taxes are additional charges paid to the government authorities of the respective countries
**OFW Y refers to Overseas Filipino Worker flying Economy class*

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