

For Information

**Legislative Council Subcommittee
to Follow Up Issues Relating to the
Three-runway System at the Hong Kong International Airport**

**Financial Arrangement Plan of the
Three-Runway System (“3RS”) Project**

Introduction

This paper sets out Airport Authority Hong Kong’s (“AAHK’s”) response to the issues raised by Hon Dennis Kwok in his letter referenced LC Paper No. CB(4)694/15-16(01).

A. Legal opinion on the basis of levying the new Airport Construction Fee (“ACF”)

2. In LC Paper No. CB(4)399/15-16(01), AAHK has set out the relevant legal provisions under the Airport Authority Ordinance (“AAO”) that provide the basis for AAHK to levy the proposed Airport Construction Fee (“ACF”) (recapped at the **Annex**).

3. On three recent applications for leave to apply for judicial review seeking to challenge the legality of, amongst others, AAHK’s financing arrangement for the three-runway system (“3RS”), the High Court ruled that AAHK has express power under the AAO to charge the ACF. The Court considered that the construction of the 3RS falls within AAHK’s function to develop the Hong Kong International Airport (“HKIA”), and that the imposition of the ACF is requisite or expedient for the performance by AAHK of that function and thus falls squarely within AAHK’s power under section 7(2)(i) of the AAO.

4. Given that AAHK is engaged in legal proceedings of judicial review involving, amongst other things, AAHK’s proposals on ACF and in order to protect its legal privilege (and as advised by the external lawyers acting for AAHK in such judicial review proceedings), AAHK is unable to produce the legal opinion it received as requested. In any event, the decision of the High Court has clearly confirmed the basis of AAHK’s legal power to charge ACF.

B. Financial Internal Rate of Return (“IRR”) for the 3RS Project

5. On the question regarding the difference between the projected 3% financial IRR in the 2011 report prepared by the Hong Kong and Shanghai Banking Corporation (“HSBC”) and the projected financial IRR of 8% in the 2015 report prepared by HSBC, as explained in LC Paper No. CB(4)589/15-16(01), it should be noted that the two reports are very different in nature. The baseline against which the IRRs were calculated, as well as many of the assumptions adopted in the two reports are also different. The two sets of IRR figures therefore do not offer any meaningful comparison. The key differences between the two reports are recapped below for Members’ reference.

6. The 2011 study was a “financial feasibility study” undertaken as part of the Master Plan 2030 (“MP2030”). Its primary purpose was to assess the financial feasibility between the two-runway system (“2RS”) and 3RS development options. For the purpose of calculating the financial IRRs, the 2011 study has adopted the traffic forecast projected in 2010 and capped at approximately 60 million passengers per annum (“mppa”) in financial year 2015/2016 as the basis for comparing the 2RS and 3RS scenarios¹.

7. On the contrary, the 2015 study was a “financial arrangement study” for the 3RS. Its primary purpose is to develop a financial arrangement plan to fund the 3RS. Annex A to LC Paper No. CB(4)589/15-16(01) sets out the key differences between the 2011 and the 2015 HSBC studies. The financial IRR for 3RS in the 2015 study is calculated based on incremental cashflows (i.e. revenues, operating expenses and capex) generated by the 3RS project relative to a two-runway baseline (i.e. traffic capped at 77 mppa or 420,000 air traffic movements per annum) until financial year 2046/47, after taking into account incremental tax plus terminal value. Moreover, the 2015 study has adopted, among others, updated working assumptions to reflect developments since 2011, such as :

¹ The financial year 2015/2016 was adopted as the basis for the assessment in view of the major infrastructural investment committed at that time (i.e. the Midfield Development, which was commissioned in 2016). The IRRs for both the 2RS and 3RS scenarios were then calculated on the basis of their respective investments and returns from 2016 onwards.

- (a) the most updated 3RS cost estimate (increased from \$136.2 billion under MP2030 to \$141.5 billion), both in Money-Of-Day (“MOD”) terms;
- (b) traffic forecast updated in 2012 for the purpose of the Environmental Impact Assessment study (as opposed to the traffic forecast estimated in 2010); and
- (c) the incremental cash flow with the known sources of funding, such as ACF, increases in airport charges etc..

8. The 2011 financial feasibility assessment showed that the project financial IRR was 3% (pre-tax) while the 2015 financial IRR was approximately 8% (post-tax). It should be noted that at the time when the 2011 study was conducted, only the size of funding gap was determined. Neither the source nor the cost of funding had been assessed. Hence, without these key financial data which have impacts on the tax expenses, only the pre-tax IRR was assessed. In the 2015 study, with the size of funding gap updated and the source of funding determined, our financial adviser was able to assess the post-tax IRR. In any event, HSBC assessed that the difference between the pre-tax and post-tax IRRs for the 2015 study was immaterial (i.e. both were approximately 8%). Most importantly, it is the economic benefits, rather than the financial IRR, that matters most in developing the 3RS.

C. Key Risks and Potential Downside Scenarios Assessed by HSBC

9. It should be noted that the assessment of the impact of the five potential downside scenarios by HSBC in the 2015 report was undertaken to test the financial robustness and prudence of the 3RS financial arrangement plan. These scenarios were used to test the ability of AAHK to raise additional debt to meet the funding shortfall whilst maintaining financial ratios consistent with an underlying rating of investment grade (section 6.2.1 of the 2015 HSBC report).

10. The credit ratings mentioned in the 2011 HSBC report referred to AAHK’s underlying credit rating as a standalone entity as a reference to the rating methodology of the credit rating agency at the time (i.e. Standard and Poor’s). It should be noted that the underlying credit rating will likely be different from the actual final rating determined by rating agencies at the time as the latter would, as a matter of practice, take into account the fact that AAHK is wholly owned by the Hong Kong

Special Administrative Region Government. This approach is consistent with the general approach for rating public sector entities in Hong Kong.

11. In the five scenarios tested under 2015 Report, HSBC concluded that “the results indicate that in these downside scenarios AAHK’s financial ratios would remain at or near to levels consistent with an underlying rating of investment grade”. HSBC, as the financial adviser to AAHK, should not be placed to represent credit agencies’ views on the AAHK’s underlying credit rating.

12. While it is inappropriate for AAHK to speculate on its investors’ desire to invest in bond, it should be emphasized that HSBC has already assessed and opined that AAHK can raise the additional funding under the five downside scenarios from the capital market on reasonable terms.

Advice Sought

13. Members are invited to note the additional information set out in this paper.

Airport Authority Hong Kong
April 2016

Legal Basis for Charging the ACF
under the Airport Authority Ordinance

1. Section 5(1)(a) of the AAO states that AAHK “shall, in accordance with this Ordinance and also in accordance with the objective of maintaining Hong Kong’s status as a centre of international and regional aviation, provide, operate..., develop and maintain, at...Chek Lap Kok, an airport for civil aviation.”
2. Section 7(1) of AAO states that AAHK “shall have the power to do anything which is requisite or expedient, or is calculated to facilitate, or is conducive or incidental to, the performance of any of its functions and which is not inconsistent with any other provision of this Ordinance...”
3. Section 7(2) of AAO states that without affecting the generality of section 7(1) of AAO, the AAHK “may...subject to section 34 where applicable, determine the amount of charges and fees.”
4. Section 34 of AAO does not apply to ACF because Section 34 of AAO only concerns “airport charges” which are specially defined in Section 2 of AAO.