

**For Discussion
on 7 February 2017**

**Legislative Council Subcommittee
To Follow up Issues Relating to the
Three-Runway System at the Hong Kong International Airport**

**Cost and Financial Arrangement Plan of the
Three-Runway System**

Introduction

1. This paper provides an update on the cost and financial arrangement plan of the Three-runway System (“3RS”) project.

Background

2. The 3RS project is the single largest infrastructural development planned for the airport since its opening in 1998. The project goes beyond building just a runway. It involves seven core components including approximately 650 hectares of reclamation; a new runway and taxiways; a new passenger building and terminal; automated people mover and high-speed baggage systems; as well as supporting utilities and facilities, the scale of which can be compared to constructing a new airport. Having critically reviewed the scope of the 3RS project (details of the scope of project were previously set out in LC Paper No. CB(4)275/15-16(01)) and on completion of the scheme design, Airport Authority Hong Kong (“AAHK”) estimated that the capital cost of the 3RS to be \$141.5 billion in money-of-the-day prices.

3. Subsequent to the Executive Council’s (“ExCo’s”) in-principle approval in March 2012 for AAHK to take forward the planning work relating to the development of the 3RS, AAHK appointed The Hongkong and Shanghai Banking Corporation Limited (“HSBC”) as its financial advisor to devise a possible financial arrangement plan for implementing the 3RS project. The study, amongst others, examined the various sources of funding for the project. In September 2015, the ExCo noted the financial arrangement proposal for the 3RS project. Members of the former Subcommittee were briefed on AAHK’s financial arrangement plan for the 3RS project at its meeting held on 5 January 2016 (LC Paper No. CB(4)399/15-16(01)). The

relevant study report has been uploaded onto AAHK's webpage in December 2015 for public reference (http://info.threerunwaysystem.com/pdf/en/3RS_financial_arrangements_report.pdf).

Financial Arrangement Plan

4. In devising the financial arrangement plan, AAHK has adopted the “joint contribution and user-pay” principle under which users of the Hong Kong International Airport (“HKIA”), i.e. passengers and airlines, as well as aviation-related businesses should jointly contribute to the project cost. AAHK has proposed to fund the 3RS through the following three sources :-

- (a) retaining AAHK's operating surplus including, inter alia, reviewing and optimizing existing fees and charges;
- (b) introducing a new Airport Construction Fee (“ACF”); and
- (c) raising third party debts from the market leveraging on AAHK's financial capability and excellent credit rating.

5. The breakdown of the 3RS funding sources is set out at **Annex A** and elaborated in the following paragraphs.

(a) Retaining Operating Surplus

6. Section 26 of the Airport Authority Ordinance (“AAO”) stipulates that AAHK may declare and pay dividends to the Government. It is therefore for the AAHK Board to decide whether to declare dividend, and the amount of such dividend, if any.

7. In accordance with the 3RS financial arrangement proposal submitted to the Government in 2015, AAHK would retain all distributable profits from FY2014/15 onwards until the commissioning of the 3RS which is expected to be in 2024. The decision of retaining operating surplus for the purpose of funding the 3RS project was duly considered and approved by AAHK Board. With the Board's approval, AAHK has retained distributable profits for the past two financial years (FY2014/15 and FY2015/16) to provide funding for the 3RS project.

8. At the same time, AAHK will optimize various revenue sources to provide funding to the 3RS project, including adjusting the landing and parking charges. Due to the Asian Financial Crisis in 1999, AAHK reduced the landing and parking charges by 15% in January 2000. Since then, the landing and parking charges had remained at the reduced level. After having consulted airlines and key stakeholders, AAHK proposed to restore the level of charges roughly back to the pre-2000 level over a three-year period, with subsequent adjustments in line with inflation. The ExCo gave approval in June 2016 for AAHK to implement the revised landing and parking charges scheme which then took effect in September 2016.

9. AAHK estimates that about \$47 billion (or 33% of the project funding) would be raised through optimizing revenues (including the above increase in landing and parking charges) and retaining all distributable profits.

(b) Introducing ACF

10. The AAO empowers AAHK to levy the ACF. The legal basis for charging the ACF, set out in LC Paper No. CB(4)399/15-16(01), is attached in **Annex B**. The ruling of the High Court handed down with respect to three judicial review cases in March 2016 further affirmed AAHK's power granted by AAO to charge the ACF.

11. The ACF regime differentiates charging levels for short haul/ long haul passengers, first or business class/ economy class passengers, and origination and destination/ transfer and transit passengers. The amount of ACF to be collected ranges from \$70 to \$180 per passenger. Members were briefed on the ACF regime at the meeting of the former Subcommittee on 3 November 2015 and the charging mechanism is set out in **Annex C**.

12. AAHK has begun collecting the ACF on air tickets issued from 1 August 2016 for departing passengers at HKIA. ACF will remain in effect until all the 3RS-related borrowings have been fully repaid, which is expected to be in FY2030/31. It is AAHK's intention to maintain the charging levels of ACF throughout the collection period. AAHK estimates that about \$26 billion (or 18% of the project funding) would be raised through collecting the ACF.

(c) **Raising Funds from the Market**

13. Taking account of the funding sources outlined in paragraphs above, there remains a funding shortfall of \$52 billion. To fill this funding gap, AAHK plans to borrow/raise funds from the market. Together with the estimated borrowing cost of \$17 billion, the total incremental borrowings will be \$69 billion which will be raised from the market in phases.

14. Operating on prudent commercial principles, AAHK has a good track record of raising debts to finance its operation and enjoyed access to a wide range of financing options, including bank and bond markets. These markets have sufficient liquidity to fund the \$69 billion incremental debt required by AAHK. As recently as December 2015, AAHK successfully closed a \$5 billion revolving credit facility with 21 local and international banks on a club deal basis. The pricing of the deal was the lowest among club or syndicated bank loan deals in Hong Kong market with the same tenor over the previous 48 months at that time. This clearly demonstrated AAHK's ability in obtaining funding from the market on very competitive terms.

15. According to HSBC, AAHK's financial advisor, with AAHK's reputation, its financial capability, its 100% ownership by the Government and its excellent credit rating (Standard and Poor's: AAA), AAHK would be able to raise sufficient funds on competitive terms from the market.

16. The financial advisor has also conducted a risk assessment of different scenarios and undertaken "what-if" analysis for five hypothetical downside scenarios¹ for testing the financial robustness and prudence of the 3RS financial arrangement plan and evaluate whether the plan could manage the impacts under such scenarios. After prudent assessment, the financial advisor concluded that AAHK is capable of raising debt to fund the 3RS, and the overall financial arrangement for the 3RS is practicable and viable. The financial advisor considered that, in the event that these downside scenarios were to occur, AAHK would still be able to maintain an investment grade rating and raise further debt to fund the consequential funding shortfall for meeting the project expenditure.

17. The financial advisor also reiterated that the above hypothetical downside scenarios were for sensitivity testing purpose only and did not reflect its expectation of possible outcomes. AAHK stressed that the

¹ The five hypothetical downside scenarios include: (1) a 15% decline in AAHK's total revenue; (2) a 20% overspend on 3RS capital cost; (3) a 50% overspend on 3RS capital cost; (4) single adverse event e.g. similar to the SARS outbreak in 2003, leading to a decline in passenger throughput and air traffic movements; or (5) a 2% increase in the cost of borrowing.

downside scenarios selected in the tests already represented very critical situations and were sufficient to test the viability of the 3RS financial arrangement plan and hence no other tests are necessary. The financial advisor recommended that in case the financial impact of the downside scenarios was more severe than assumed, AAHK should revisit its financial plan and may develop other revenue streams or access alternative forms of financing other than senior debt.

18. In December 2016, as a follow up to the overall 3RS financial arrangement plan announced by AAHK in 2015, AAHK appointed HSBC as its financial adviser to study the detailed funding plan for the \$69 billion incremental debt. The financial adviser will analyse different debt structures and identify different forms of financial instruments in both the bank loan and capital markets, and make detailed recommendations on the instruments (such as retail bonds, where appropriate and practicable, to increase public participation in the 3RS project) in relation to timing, size, tenor, etc., that will enable AAHK to raise funding for the 3RS project in the most optimal manner. While not pre-empting the outcome of the study, some possible financial instruments to be considered are set out in **Annex D**. The study is expected to be completed by mid-2017.

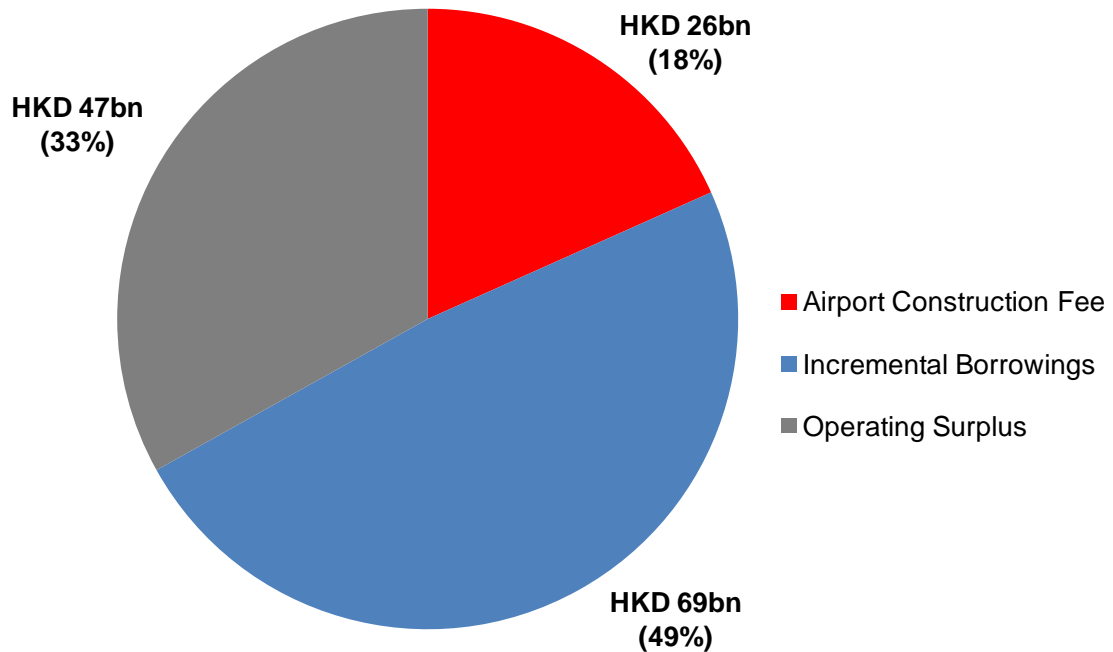
The Way Forward

19. In anticipation of completing the detailed funding plan by mid-2017, AAHK will monitor the market conditions closely. Upon completion of the detailed funding plan and subject to the Board's endorsement, AAHK will execute the plan as the market allows, and will consult the Government and the Hong Kong Monetary Authority from time to time. AAHK will also be pleased to brief the Subcommittee again if necessary.

Advice Sought

20. Members are invited to note the content of this paper.

Breakdown of 3RS Funding Sources



Source: AAHK, 3RS Consultancy Study: Financial Arrangement for Three-runway System (3RS) at HKIA – Financial Advisor Report, HSBC (2015)

Note :

1. The numbers above are subject to rounding.
2. As clarified at the Subcommittee meeting held on 5 December 2016, the profits to be generated from the North Commercial District will not contribute to the financing arrangements of the 3RS.

Legal Basis for AAHK to Charge the Airport Construction Fee (“ACF”)
Under the Airport Authority Ordinance (“AAO”)

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, 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.
5. As made clear in Section 2 of AAO, the definition of “airport charges” ONLY “means charges payable in connection with the landing, parking or taking off of aircraft at the Airport”.

Charging Mechanism of ACF Regime

ACF (HK\$ per departing passenger)		First/ Business Class	Economy
	Long haul	\$180	\$160
Short haul	\$160	\$90*	

* To maintain the competitiveness of HKIA’s hub status, ACF for short haul economy TT passengers is set at \$70.

Notes :

1. “Long Haul” refers to destinations in North and South Americas, Europe, the Middle East, Africa, Southwest Pacific and the Indian Subcontinent while “Short Haul” refers to all destinations other than Long Haul destinations.
2. “Economy Class” refers to all other classes of travel, such as “Premium Economy Class,” the standard “Economy Class,” etc.
3. “Origin-Destination” refers to passengers originating from HKIA. “Transit” refers to passengers arriving and departing on the same aircraft under the same flight number without passing through arrival immigration control at the Airport Area (as defined under the AAO) while “Transfer” refers to passengers arriving and departing on the same day (within 24 hours), on different aircraft and under different flight numbers.

**Possible Financial Instruments
to be Considered in the Detailed Funding Plan**

(a) Long tenor bonds

AAHK has a strong track record of tapping the HKD and USD bond markets and local and international investors will likely have a keen interest in AAHK's bonds. Therefore, institutional bonds will be an attractive financing option for AAHK's core debt. Such funding is of minimal risk because of its long tenor (reducing refinancing risk) and fixed interest rates. Long tenor bonds are most appropriate for long life infrastructure projects such as 3RS. As such, they will likely form a core part of AAHK's whole financing plan for 3RS. While market capacity in HKD bonds is limited, the USD markets provide substantial liquidity, provided that the credit and pricing are appropriate. Foreign exchange risk will need to be considered and managed for non-HKD bond issuance.

(b) Retail bonds

A portion of the incremental borrowings will likely be in the form of retail bonds to increase public participation and engagement in the 3RS project. This will be perceived positively since the bonds would allow the participation of the general public in the 3RS and enable them to take home financial benefits arising from investment in the project. However, the tenor of retail bonds is likely to be short when compared to the long term nature of the 3RS investment and the pricing may be less competitive when compared to other sources. Hence, the quantum and terms of retail bond issuance will require further study.

(c) Green Bonds

As outlined in the 2016-17 Budget, green financial business investing in environmental projects is gaining attention in the global market. With the range of green and sustainable features incorporated into the design, construction and operational aspects of the 3RS project, there are a number of projects which can potentially be qualified for green bond financing. This should offer AAHK a new way to diversify its funding source from the traditional bond market.

(d) Islamic Bond/Sukuk

Sukuk will also be considered. The Government issued two Islamic bonds in 2014 and 2015. The bonds were issued to increase the profile of Hong Kong as a centre for Islamic finance and as a template for other issuers to utilize Hong Kong to issue their Islamic bonds. Islamic bonds are more complex than conventional financing and in the short term are unlikely to offer a pricing advantage. However, there may be a strategic benefit in diversifying the investor base supporting AAHK to include investors in various parts of the world seeking Islamic compliant structures. If AAHK were to issue Islamic bonds, it would likely represent a small portion of the overall financing.

(e) Commercial bank loans

AAHK has established good relationship with major regional and international banks and has been an active participant in the Hong Kong syndication bank loan market. There is currently good market liquidity with appetite to lend up to 5 to 7 years at competitive costs. Longer term commercial bank loans could be available with the support of export credit agencies for certain imported components of the 3RS project. Strong appetite to lend to AAHK is therefore anticipated. The tenor of bank loans could be complementary to the long dated bond. The bank loan market could provide an important funding source for AAHK.

(f) Revolving Credit Facilities

AAHK has maintained revolving credit facilities and this is considered important for 3RS to provide new financing and a flexible buffer in case capital expenditure is faster than expected or if the capital markets are closed or unattractive for a period of time. As mentioned in paragraph 14 of the main paper, AAHK signed a five-year \$5 billion revolving credit facility in early December 2015 with 21 local and international banks.
