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Sustainable Financing for the Hong Kong International Airport

On July 6, 1998, the momentous landing of Cathay Pacific flight 889 at Chep Lap Kok on Lantau Island signaled a new era. Not only was the occasion significant for the former British colony, in many ways the event also solidified China's transition from the Communist Autocracy, haunted by the 1989 Tienanmen Square crackdown, into the quasi capitalist modern economic power it is today. Though their work was far from over, Airport Authority Chairman Mr. Wong Poyan, and his new Finance Director Raymond Lai could take a brief moment to celebrate a giant step forward in the life of Hong Kong's most important development project: The construction of the new Hong Kong International Airport. [1]

Figures 1 & 2. Hong Kong Map, courtesy of Asia Online

Justin Chapman, MDES '11, wrote this case study under the supervision of Dr. Andreas Georgoulias, Lecturer in Architecture, as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

The Global Politics of Infrastructure Development

The seeds of this hard earned victory sowed their roots in 1984, when the British and Chinese governments signed the Sino- British Joint Declaration on the future of Hong Kong. This was the finale of a long saga begun in 1898, when a 99 year lease ceded control of the territory to the British. The topic of an early return to China had been raised at various points during the 20th century, however the politics were not favorable action. By 1982, Margaret Thatcher attempted to assert Britain's continued control over Hong Kong to no avail: Deng Xiaoping, through the Daily news would announce:

> *"The Chinese leaders will officially inform British Prime Minister Thatcher during their talks that China is determined to regain complete sovereignty over the New Territories, Kowloon and Hong Kong Island in 1997 when the lease on the New Territories expires... thus concluding British rule over Hong Kong..."*

Thus, the 1984 Declaration established Hong Kong as a "Special Administrative Region" ultimately to be controlled largely by Beijing, as of July 1, 1997. This concept created natural tensions between the politico-economic interests of British and China, and the socio political concerns of Hong Kong's citizens, who had been colonized for 150 years. Britain sought to maintain full access to the economic fruits of its eastern empire. China wanted to tighten its control of the administration over Hong Kong - the major channel by which Beijing accessed the capital markets. According to a New Sunday Times journalist in 1991,

> *" China owns 2000 companies in Hong Kong, many through the China International Investment Corporation. It is buying into many key industries, and already owns half a dozen newspapers, owns 25% of the new cross harbour tunnel, 12.5 % of Cathay Pacific, 28% of Dragonair, and 20% of its phone company. It also supplies Hong Kong with 72% of its fresh water and food supply".*

China was also the biggest importer of goods from Hong Kong, which benefitted both western companies, and local workers. However, many in the active Hong Kong political scene were critical of the Communist regime in Beijing. These tensions came to a head in the years immediately after Deng Xiaoping's violent crackdown on student protestors at Tienanmen Square.[2] The tensions are clearly highlighted in this excerpt from International Affairs in 1993:

> *The Chinese suspect a long-standing British design to abscond with the surplus capital of Hong Kong and to leave the territory in disarray in the hands of an influential pro-British group. Indeed, since the Tienanmen events of I989 and the collapse of communism elsewhere, China's leaders have suspected that the British are in league with others in seeking to subvert communist rule in their country. For their part, the British have perceived the Chinese leaders as ill-informed and brutal in their exercise of power; and their negotiators have been likened to street fighters.* [3]

Under these circumstances in late 1989, British Governor of Hong Kong David Wilson was already promoting a new airport to build international confidence in the Hong Kong transition, given the post Tienanmen sentiment. Because the Chinese feared the British would use the airport to draw finances away from a nascent economy, they insisted on approval rights in additional to limits on the amount borrowing that would impact Hong Kong post 1997. Additionally, financing by the new Hong Kong government would not be attractive to investors without significant Chinese guarantees, making support from Beijing essential. With this stage set, a memorandum of understanding was signed by the UK and China in 1991 that gave Beijing a significant stake in the decision making and control of the airport, along with the transition generally. Because of this, UK Prime minister Jon Major replaced David Wilson with Chris Patten to oversee the process.[4]

Hong Kong Kai Tak Airport and Regional Context

Because of its historical place as the seat of the Asian British empire, Hong Kong was established as arguably the most important city to Southern China, and the Pacific Rim. As a result, the main airport, Kai Tak became of equal significance. Originally built in 1925 as a flying school and a British military unit, the airport would eventually grow to handle over twenty nine million passengers annually by 1996.[5] Several studies beginning in 1946, contemplated a new site for Kai Tak. In 1946 and 1951, The Hong Kong government commissioned proposals from British engineers, who ultimately opted to the extend the existing single runway. By 1973, the government had singled out Chep Lap Kok as the desired replacement site, but the financial and oil upheavals of the mid 1970's put an end to any hopes of implementation. As the eighties approached however, it became clear that Hong Kong would revert to the Chinese, and that the relocation of the airport would be a pivotal piece in the transition.[6]

Figure 3. The Dense Urban Approach at Hong Kong Kai Tak. Courtesy Airliners.net

Figure 4. The Dense Urban Approach at Hong Kong Kai Tak. Courtesy Airliners.net

The demographic and air traffic trends signified the economic impact of Hong Kong in the region. By 1995 according to writer Harry Walters, Hong Kong handled three-fourths of all products shipped from mainland China. From 1960 to 1995, the population had doubled from 3 million to 6.2 million. As Hong Kong became one of the most dense cities in the world, residential construction put thousands of homes in the approach paths of commercial aircraft.[7] This fact, both dangerous and inconvenient, was unsustainable, and helped spur the move to a new site. An article in Aviation Week and Space Technology explained:

> *Safety also is a factor. Fully laden 747s must perform a tricky 47-deg. turn on most approaches to Kai Tak, ending at 674 ft. above ground level. The World War 2-vintage runway also has insufficient overrun area and is surrounded by one of the most densely populated urban areas on earth, with 350,000 people living under the flight paths. Fewer than 1,000 people live under the approaches to Chep Lap Kok.*[8]

The Provisional Airport Authority and the Value Proposition

Based on the Memorandum of Understanding, signed in late 1991 by Jon Major and then Chinese Premier Li Peng, two quasi governmental bodies were established to oversee and implement the contentious vision for the new airport. The Sino British Airport Committee board negotiated the financial and policy framework that would be carried out by the Provisional Airport Authority, which was charged with designing and developing the project. A true public private partnership, seven members of the provisional board were high level public servants such as the Secretary of Transport or Economic Services. The remaining eight came from varying private sector roles like banking and development.

Despite the divisions and political disagreements, the decision makers in charge of the project understood the seriousness of the situation. The success of the Hong Kong transition was the underlying factor driving the the team. To create value, the Provisional Airport Authority needed to finance and deliver ten major infrastructure projects that included the airport itself, tunnels and bridges connecting the island with Kowloon, a rail connection, and additional cargo and freight terminals. Hong Kong's new jewel would be a massive undertaking.

> *The Chek Lap Kok reclamation and earth-leveling project will be one of the largest ever undertaken, according to airport officials. Over 90 million cubic meters (118 million cu. yards) of rock will have to be moved and 75 million cubic meters (98 million cu. yards) of marine sand acquired to create the 1,275-hectare (3,150-acre) island. The job includes leveling 80-meter-high peaks on Chek Lap Kok and Lam Chau islands, which the airport platform will be built around. The U. S. Consulate in Hong Kong estimates that the finished project will be one of the few man-made objects visible with the naked eye from space, similar to the Great Wall of China and Egypt's pyramids.*[9]

The project was the culmination of the Port and Airport Development Strategy, the final stage of evolution in Hong Kong's comprehensive master planning policy that began in the early 1970's.[10] Thus, each stakeholder sought to create socio economic benefits for the new state, while walking away with short and long term profits. The fundamental question to be answered was who controlled access to the financial value created?

Seeds of Agreement

At first, the total price tag on the project was estimated at roughly $16 Billion USD. Work began immediately in 1992, with a $536 million HKD ($69million USD) contract awarded to Foster and Partners for terminal design in March. In November, another 9.04 Billion HKD ($1.17billion USD) contract was awarded for site preparation. Both contracts were granted by the Provisional Authority to a Japanese led consortium just after the Hong Kong Legislature approved up to $1.5 Billion USD in financing *without the approval of the Chinese government.* Even though Hong Kong Financial Secretary and Provisional Board member Hamish McLeod declared that Hong Kong would not "go it alone", the move caused China to openly criticize the now bloated $22 billion dollar plan. In fact, China immediately declared all contracts and debts issued by Hong Kong null and void after the transition date of July 1, 1997.[11]

The fact was that British economic interests still had a very significant, if slowly diminishing role to play in Hong Kong. Companies poised to reap benefits from the airport project and transition generally included Swire, who owned 50% of Cathay Pacific Airlines, owned Coca Cola franchise in South China, and a 250 million UK Pound development site in Kowloon. Additional UK interests included Hong Kong and Shanghai Bank (HSBC) and HK Telecom. Jardines Matheson, a firm contracted to develop air cargo and port container terminals part had been "accused by Peking of interfering in Hong Kong Politics, and scuttling back to London" according to Sir Charles Powell, company director, and former Thatcher advisor.[12]

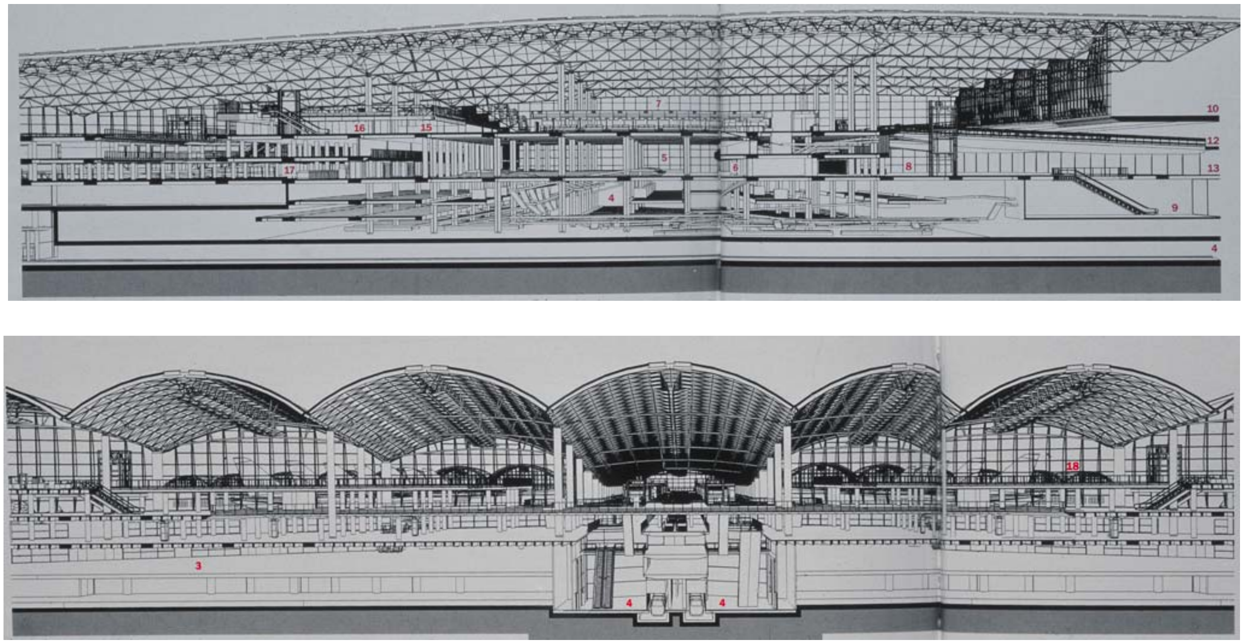


Figure 5 & 6. East-West (top) and North-South (bottom) design elevation. Courtesy Foster and Partners

Proponents of the airport had every intention on substantial completion by the 1997 deadline. By 1993, the Japanese joint venture of Kumagai (HKC)/HAM/Maeda was well into executing the advanced airport works and preliminary site preparation. By June of 1994, the $465 HKD contract for the passenger terminal foundation was awarded to the Gammon Construction and Nishmatsu joint venture, and it appeared there would be no turning back. Indeed, in late 1994, Governor Patten and Li Peng reached an accord regarding the future of Chep Lap Kok. Finally, in June of 1995, the reluctant partners agreed on a financing structure that would allow the ultimate Airport Authority to borrow money in the capital markets with some oversight form the Chinese, Hong Kong's ultimate guarantor.

Financing Structure

The Sino British Joint Committee, through the Provisional Airport Authority (later the Hong Kong Airport Authority), approved or sanctioned 58 contracts totaling $34.5 Billion HKD for the construction of the Airport Core Program (ACP) between 1991 and 1997. Under the agreement signed in 1995, the Hong Kong Government could inject equity into infrastructure projects supported by both the airport authority, and the Mass Transit Railway, which operated the metro subway system that was to extend from downtown to the new airport. Between the two entities, over $60.3billion HKD was committed by the Hong Kong government. The most essential piece of the legal structure negotiated in the 1995 agreement saw the Chinese allow the airport authority to issue bonds as a government entity, and also to borrow funds in the capital markets. Post 1997, such borrowing would be limited to $5 billion HKD in any capital raising exercise. Now, The Hong Kong Airport Authority could essentially act independently as the operating executive with regard to implementing its vision for the Airport Core Program. Railway Transit finance director Roger Moss was quoted as saying" We've suffered like Job for this. It will take us all of two and a half minutes to start issuing bonds".[13]

Indeed, 1995 proved to be a benchmark year for the project. With the agreement standing firm, the Provisional Authority was transitioned, and construction trades advanced the project timeline with speed. Three significant deals were struck for the construction of the main passenger terminal (BCJ Joint venture), terminal building services (AEH joint Venture), and the first runway (Downer- McAlpine joint venture). The contracts totaled $10.1, $1.8, and $2.61 billion HKD respectively. These funds were all sourced from the $34.5 billion in government injections that would convert to equity at the end of the year. The conversion of government funds into equity was meaningful, because it signaled that the Hong Kong government meant *business* in terms of its stake in the project. The positioning enabled the Hong Kong SAR via the newly established Airport Authority to establish "skin in the game" with regard to the pubic private partnerships it would from from this point,and use to expand its reach future.

Two events indicated the new strategies. In November of 1995 , the first of several ongoing major credit facilities was originated through a consortium of eleven different banks $8.2 billion HKD ($1.05 USD). The loans were used to complete the first phase of the ACP. It is key to remember that this financial arrangement was the last to be executed before the official transition of Hong Kong into Chinese hands in June of 1997. Strategically, it nearly maximized the transitional government borrowing limit of $1.5 billion USD, and all but assured the project would be completed, with some delays. Perhaps the most interesting development of 1995 was the leasing of a 3.3 hectare (roughly 8 acre) land area to Cathay Pacific for its new headquarters. The airline had plans to spend over $3.5 billion HKD on the project, which would provide a consistent source of operating income for the Airport Authority. Additional bond issuances would take place in late 1997, 2000, and 2001. By the year 2000, the emergent quasi public body was reporting profits of $291 million HKD. International confidence in the authority was clearly growing, reflected by the over-subscription to all of its bond issuances, attracted eight times more supporters than there were bond notes. Credit ratings rocketed to A+ or AA status from Standard and Poor's by then end of 2001. By all empirical measures, the project was becoming a resounding success.[14]

The Rise Of The Aerotropolis

When Cathay Pacific flight 887 landed at Chep Lap Kok in July of 1998, all parties involved could breathe freely, if only for a moment, knowing that the hard work, political struggle, and financial engineering had paid off. Members of the team could be proud of the fact that the success of the HKIA project lay not only in the role it played in the political transition of Hong Kong, but also in its innovation as an emerging model of airport development.

The term Aerotropolis was coined by John Kaskarda in 2000, as he studied urban land developments in Asia. He understood that business trends resulting from rapid globalization would require that time and efficiency would continually grow in importance compared with location, in terms of the value chain of individual firms, industries, and therefore national economies. In his words, " the three A's (accessibility, accessibility, accessibility) will become the critical component of the three L's (location, location, location)".[15] The visionaries at Hong Kong's Chep Kok Lap understood this idea at least twenty years earlier, and applied it in a way that allowed the airport to become financially sound, and economically indispensable to the region.

Figure 7. Chep Lap Kok completed. Courtesy earchitect.uk

Originally built to accommodate 35 million passengers annually, the airport was expanded throughout 1999 and 2000 to handle 45 million. In the 2020 HKIA Master Plan published by the Airport Authority, anticipated annual passenger demand capacity was estimated at 87 million. Actual commercial cargo flow through HKIA increased yearly from 1.6 million in 1997, to 2.4 million tons yearly. In anticipation of the growth in these numbers, the Hong Kong government sought to maximize the economic benefits by considering the airport project as one piece of a much larger, comprehensive scheme that included the construction of:

- West Kowloon land reclamation
- West Kowloon Expressway Connection
- West Harbour Crossing
- 2 suspension bridges
- North Lantau Expressway and Rail Crossing
- Rail stations
- Additional Airport railway
- Container Terminal and freight handling facilities
- Tung Chung New City (40,000 residents, schools, police etc)
- Improvements to Mass Transit Railway

Indeed, ACP coordinating manager and Bechtel senior vice president James van Hoften flatly stated "they don't get any bigger than this". When commenting on the British-Japanese joint venture formed to construct the bridges he mused " that project by itself would be spectacular anywhere. Here, it's just 'by the way'...". It was becoming evident that the value created by the overall program was in the increased efficiency in the movement of people and goods. The effects of the HKIA would be felt far from the runways on Lantau Island.[16] At the beginning of 1999, HKIA was serving over 100,000 passengers per day on an *average* of 460 flights. By

2002, thirty three million passengers would travel through the complex annually. Rising passenger and cargo throughput meant increased annual revenues via airport charges, which averaged between 40% and 45% of annual gross revenues. The Airport Authority even devised creative incentive programs to further establish Hong Kong as a major Asian hub. Airlines that established a new route from Hong King prior to 2002 would receive a rebate on the landing and gate fees charged. This kept average costs for airlines down, while increasing traffic. Consequently, the Hong Kong Government, now the principal equity holder in the airport venture, more than content.[17]

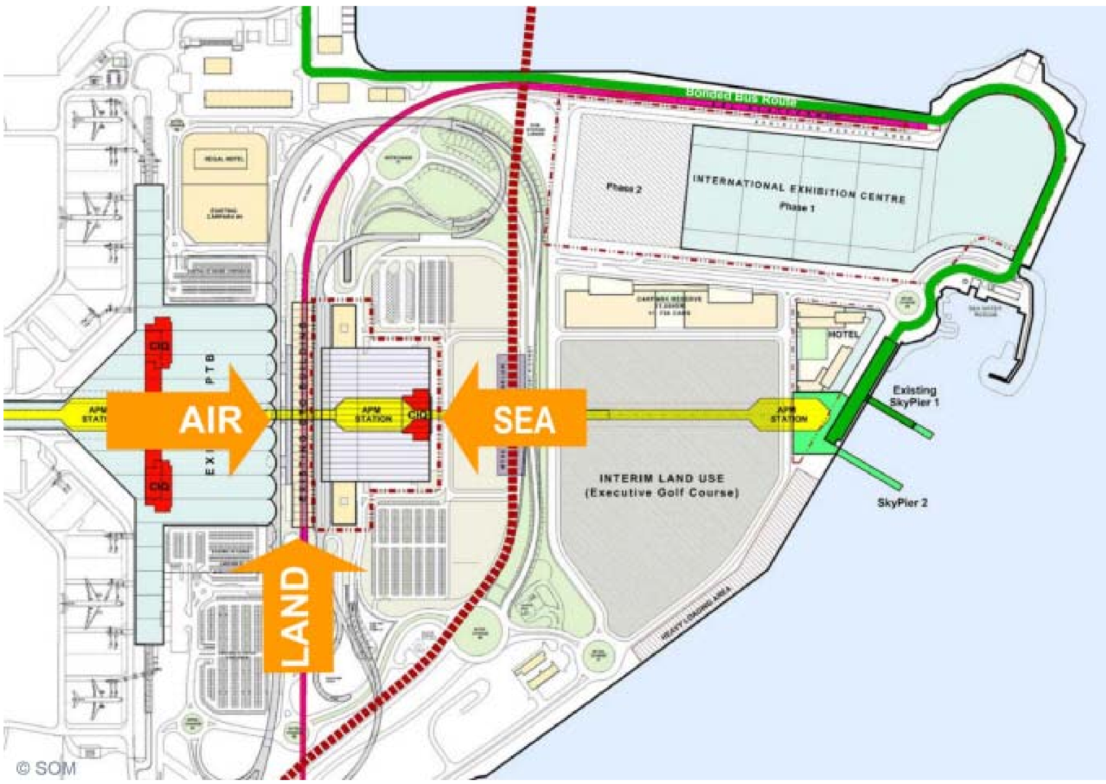


Figure 8. Chep Lap Kok Sky CIty multimodal plan. Courtesy SOM

Revenue creation, at the site level also took on some inventive forms. The AA created a subsidiary, the Aviation Security Company Limited (AVSECO), that would take care of all security services at the complex. The Regal Airport Hotel opened a 385 room hospitality center in 1999, and DHL partnered with the AA to develop an onsite express cargo and logistics center. Most important of the on site developments was the retail and terminal commercial component, which featured dozens of shopping, dining and entertainment options. Sky City contains three hotels, the Asia World Expo Center, a World Trade Center, and a nine hole golf course situated along the Lantau waterfront. The revenues, or turnover, generated from these commercial, and real estate ventures make up roughly 35% of annual gross revenues at HKIA. [18]

Figure 9.Sky City at Chep Lap Kok under construction. Courtesy Skyscrapercity.com.

Between 1999 and 2004, the project won multiple international awards, including the "Silver Medal" by the Hong Kong Institute of Architects, and the "1999 Structural Steel Design Award" in London, the Skytrax World's Best Airport four years in a row, the 2002 Global Airport Satisfaction Study conducted by J.D. Power and Associates, and the International Air Transport Association 2004 Best Airport Worldwide Award.[19] With media and industry praise coupled with growing financial stability, what could be next for the Airport Authority and its members?

The Move Toward Privatization

Things were not all positive for the Hong Kong Airport Authority in early 2004. Despite the critical accolades, passenger movement at HKIA had declined year over year by 79% between 2003 and 2003. Much of this was due to the SARS epidemic, and continued impacts of September 11th on the travel industry. To compound the problem, the Hong Kong economy had been seriously impacted by the Asian financial crisis of the late 1990's and was still in a slow recovery mode. Real GDP growth had also fallen from 10.2% in 2000, to -3.3% in 2003. Although growth was projected to recover slightly by 2004, government deficits were forecasted to balloon to $46.6 billion HKD. Like many governments faced with a similar situation, budget cuts and alternative sources of revenue was a most important topic of the day.[20]

Figure 10. Chep Lap Kok, with Tung Chung New Town construction in background. Courtesy Skyscrapercity**.**

Infrastructure privatization had been both debated and practiced globally by government agencies, policy makers, and the critics since the 1980's. British Airport Authority raised over 2.5 billion in USD funds as a result of its 1987 initial public offering. It was argued that the move brought a more efficient, corporate culture to the seven airports BAA managed in the UK. By some accounts, shares in the company appreciated to five times the initial offering price by 2001. Additionally, Hong Kong had its own experience with the 2000 public offering of 20% of the Mass Transit Railway Corporation. Though it had achieved a successful financial standing as a public entity, most of MTRC's profits were due to its extensive transit oriented land and real estate developments. The Hong Kong SAR Government saw privatization as a way to help stabilize revenue issues, in addition to gaining better access to capital markets for future growth.[21] Given the successful transfers of airports in Frankfurt and Amsterdam, the current climate could be seen as a good time to act. With this stage set, new Airport Authority chairman Victor Fung, and Chief Executive Officer David Pang announced plans to structure an IPO in August of 2003. .

> *"Privatization will reinforce the Authority's first class airport operations under market discipline and further strengthen HKIA's continued development as an international aviation hub. Not only that, it will enable the investing public, to whom we will become accountable, to participate in the growth and success of HKIA."*[22]

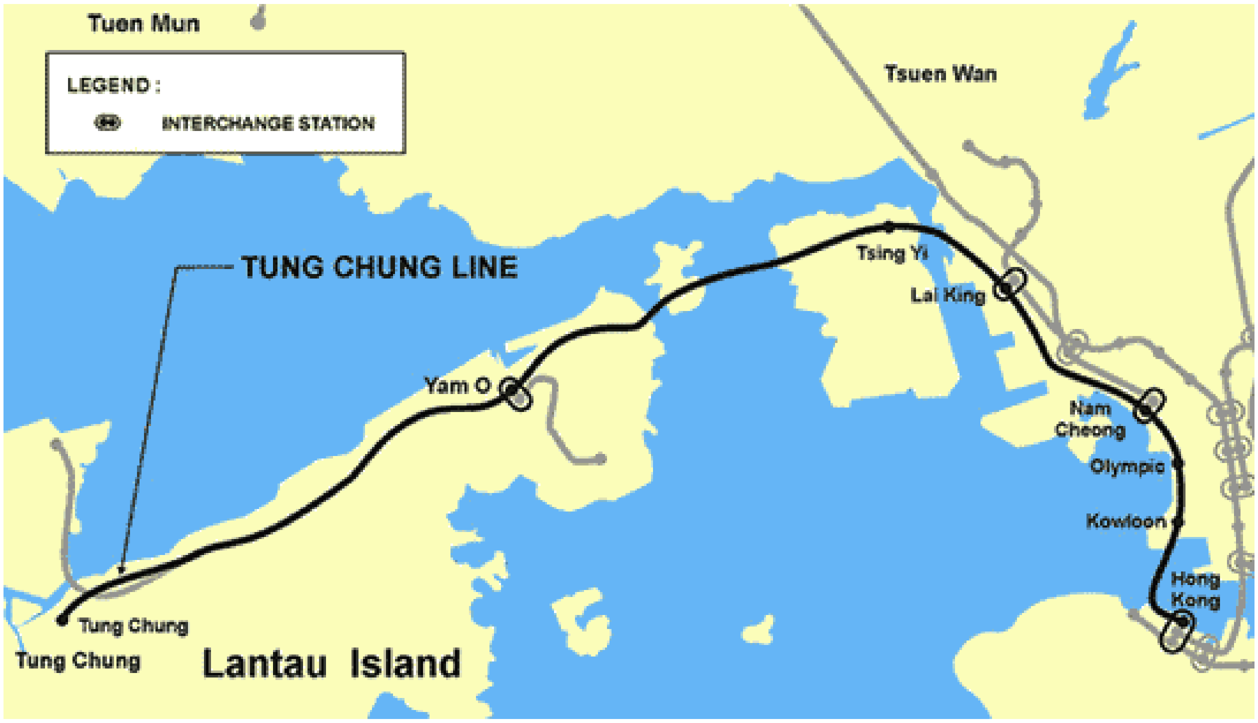


Figure 11. Tung Chung New Town rail connection line with Chep Lap Kok spur. The line was part of the Airport Core Program. Courtesy of Hong Kong Special Administrative Region Highway Department.

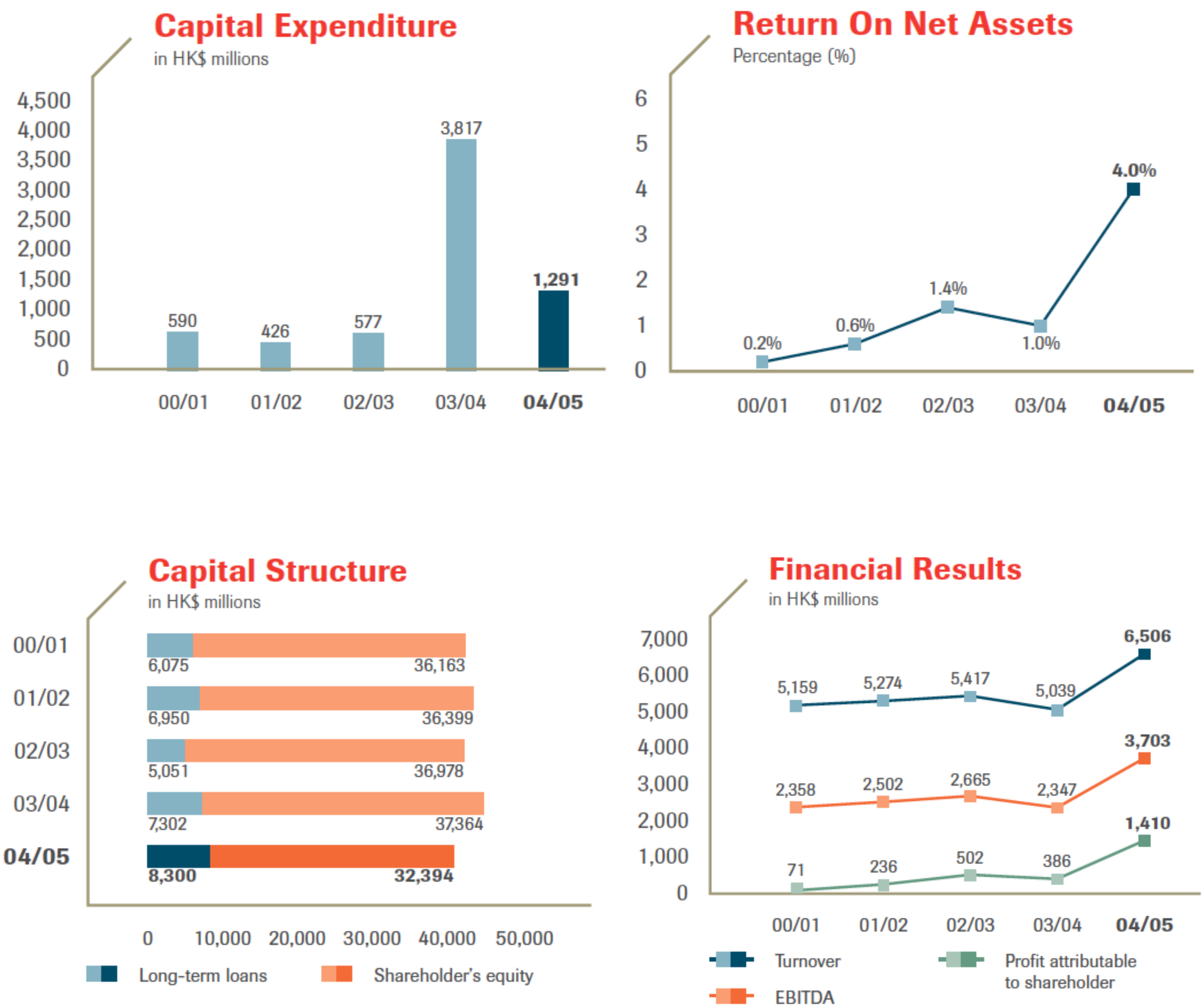
With plans to structure the deal over an eighteen month period, the AA enlisted Goldman Sachs Asia, and NM Rothschild as advisors "based on their technical, and fee proposals". [23] However, privatization was not a simply a financial maneuver. The politics of an emerging, quasi democratic economy with multiple stakeholders would be a guiding force in the ultimate outcome. Dr. Fung and Mr. Pang could look back at the fruits and accomplishments of a long process, which they now inherited, and ponder the impacts of the decision facing them.

Appendix : Financial Statements

	98/99*	99/00	00/01	01/02	02/03	03/04	**04/05**
Income Statement							
(in HK$ millions)							
Turnover	3,773	5,055	5,159	5,274	5,417	5,039	**6,506**
Operating expense before depreciation	2,282	3,057	2,801	2,772	2,752	2,692	**2,803**
EBITDA	1,491	1,998	2,358	2,502	2,665	2,347	**3,703**
Depreciation of fixed assets	(1,639)	(1,740)	(1,781)	(1,843)	(1,813)	(1,610)	**(1,685)**
Interest and finance charges	(236)	(421)	(500)	(416)	(221)	(249)	**(282)**
Profit/(loss) from ordinary activities before taxation	(384)	(163)	77	243	631	488	**1,736**
Taxation	–	–	(3)	(2)	(125)	(102)	**(322)**
Profit/(loss) from ordinary activities after taxation	(384)	(163)	74	241	506	386	**1,414**
Minority interests	(4)	(5)	(3)	(5)	(4)	–	**(4)**
Profit/(loss) attributable to shareholder	(388)	(168)	71	236	502	386	**1,410**
Balance Sheet							
(in HK$ millions)							
Non-current assets	50,737	50,242	49,029	47,579	46,360	48,527	**48,219**
Current assets	1,880	1,342	961	1,279	2,574	1,748	**998**
Current liabilities	(8,351)	(10,284)	(4,978)	(2,756)	(3,974)	(1,297)	**(3,783)**
Net current liabilities	(6,471)	(8,942)	(4,017)	(1,477)	(1,400)	451	**(2,785)**
Total assets less current liabilities	44,266	41,300	45,012	46,102	44,960	48,978	**45,434**
Non-current liabilities	(7,998)	(5,195)	(8,832)	(9,681)	(7,956)	(11,588)	**(13,010)**
Minority interests	(8)	(13)	(17)	(22)	(26)	(26)	**(30)**
Net assets	36,260	36,092	36,163	36,399	36,978	37,364	**32,394**
Share capital	36,648	36,648	36,648	36,648	36,648	36,648	**30,648**
Reserves	(388)	(556)	(485)	(249)	330	716	**1,746**
	36,260	36,092	36,163	36,399	36,978	37,364	**32,394**
Key Financial Data and Operational Statistics							
Return on net assets	(1.1%)	(0.5%)	0.2%	0.6%	1.4%	1.0%	**4.0%**
Debt/Equity ratio	0.21	0.21	0.21	0.23	0.21	0.21	**0.33**
Total passengers (millions)	21.6	30.9	33.8	33.1	34.2	27.7	**38.3**
Cargo tonnage (millions)	1.2	2.1	2.2	2.1	2.5	2.7	**3.1**
Aircraft movements (000's)	122	169	186	198	212	190	**242**

* Period from 6 July 1998 to 31 March 1999

Kkey financial data from 1999-2005. Courtesy Airport Authority.



Year by Year comparison of financial indicators 2000-2005. Courtesy Airport Authority.

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