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International Case Study: Hong Kong Infrastructure Development

Thank you for the invitation to speak to you today.

In today's presentation I will try to show how Hong Kong's strong record of infrastructure development since 1945 has underpinned its role as a global centre of commerce and trade, and how capital works have been used to stimulate the economy and to provide a confidence boost when that is needed.

I will refer briefly to Leighton's role in Hong Kong's development and the innovative approaches we have seen used by the Hong Kong Government to issues it has faced in its infrastructure programs.

In particular, I will highlight how Hong Kong is managing the latest infrastructure boom and the problems arising out of the GFC, and how its more contractor friendly approach (when compared to Australia), is dealing with some of the issues that plague Australia's infrastructure development sector.

However, let me cover a bit of history first.

Post WWII, Hong Kong embarked on an export led recovery and population growth and strong competition amongst firms fuelled an unprecedented rate of economic growth and development.

The construction of highways, tunnels, reservoirs, and high-rise buildings drove both transportation and urbanisation development at a rapid rate.

Industry diversification enabled the economy to expand beyond exporting consumer goods and electronics to become an international financial centre. Hong Kong prospered from its proximity to China. From 1960 to 1990 the economy boomed; GDP grew at over 8% per annum - three times the rate in the US. Hong Kong became known as one of the four Asian Tigers.

However, as elsewhere, Hong Kong's growth was not always consistent throughout this period. Hong Kong also faced at various times, social and political challenges.

It's interesting to quote Sir Donald Tsang, the Chief Executive of Hong Kong, on his views of economic development and infrastructure.

He said in his budget address of 2008/09, "we will promote economic development through infrastructure projects, which will create more jobs and stimulate wage increases. Over the next few years, we will vigorously implement various infrastructure projects..."

In his Policy address he went on to say that "infrastructure development can bring about huge economic benefits... the value added would be more than HK\$100 billion annually....some 250 000 additional jobs would be created".

As I mentioned earlier, Leighton has played a significant role in Hong Kong's development over many years. Leighton commenced its business there in the mid 1970's when the infrastructure development focus was on housing and transport infrastructure.

Leighton cut its teeth on site preparation works for the massive public housing projects that were implemented to house the large local and immigrant population which to that stage lived in temporary accommodation – often no more than shelters build in camps in the bush and around the steep hillsides throughout the city. Leighton prospered on this early work because it bought from Australia its knowledge of large machinery and for many years right up until the 1980's, Leighton was the only contractor running large off-road equipment in Hong Kong.

Major Social Developments.

Urban development has certainly been crucial to Hong Kong's success.

Industrial and residential construction in New Territories has helped ease population pressures in Kowloon and Hong Kong Island but nevertheless, since Hong Kong's population of 7 million people occupy a mere 250km², mobility in this densely populated city is crucial.

Transportation and urban housing development have therefore gone together hand in hand. While much of the early public housing was Government funded, progressively over the years, more and more is privately constructed.

Because that is how the Government allocated its available funds, some of the early road tunnels and harbor crossings were privately funded, while now most such works are Government direct funded.

Major Transport Developments

Public rail transport is another good example of the infrastructure developed during this period. Established in 1975, the Mass Transit Railway Corporation (MTR) identified the

need to enhance mobility and respond to the rising pressures of a growing population. To address this need the MTR built 10 major lines.

There is no doubt that an element in the success of this massive metro development program was the reputation that MTR gained among contractors as a hard but fair employer and particularly as an enlightened client. In my opinion, they are still one of the best and most effective clients anywhere in the world today.

The early 80's was a difficult period for Leighton and for others as work became scarce and competition from both local and expatriate firms increased rapidly as more and more contractors saw the potential of the Hong Kong market.

However, from the late 80's until the handover in 1997, Hong Kong and Leighton again prospered as the effects of the New Airport program and a whole raft of other infrastructure development saw the construction sector and the economy boom. As happens in Hong Kong when confidence is high everyone seems to benefit, none more so of course than property owners and speculators. Many of the spectacular bridges and roads that criss-cross the city and the harbour were built during this time.

The GFC had a devastating effect on the Hong Kong economy and GDP plunged into recession and negative growth of 3.1% in 2009.

While not as serious, the Asian currency crisis of 1997 and the subsequent outbreaks of Bird Flu and later SARS, have illustrated just how vulnerable is an economy like Hong Kong's that is so globally focussed.

The Government recognizes this vulnerability and has shown willingness and even more importantly, an ability, to react positively and effectively when such challenges arise. The view of Hong Kong as bureaucratic is just not true when it comes to getting things done. It is far more reactive than its Australian counterparts.

Following the GFC, the Hong Kong government has announced a massive infrastructure program that comprises a whole raft of mega projects. These projects cover a whole range of infrastructure and social needs.

They include:

- The South Island and The Sha Tin to Central MTR lines.
- A high-speed underground express railway service between Hong Kong – Shenzhen and Guangzhou.
- The Hong Kong-Zhuhai-Macau Corridor, which includes the design and construct of a 9km dual-three lane sea viaduct in Hong Kong waters, the reclamation of an island to house boundary crossing facilities, a 6km sub-sea tunnel, along with another 10km of tunnels and grade roads.
- The redevelopment of Kai Tak including the construction of the new cruise terminal. The entire Kai Tak Development will cost around HK\$100billion.

- The development of a West Kowloon Cultural District to support local cultural and creative industries.
- There are also plans to connect Hong Kong International Airport and Shenzhen Airport through a direct rail link, as well as developing the Lok Ma Chau Loop to the mutual benefit of both Hong Kong and the Mainland.

Mega projects aside, the HK government has also announced plans to increase healthcare spending from 15% of the Government's recurrent expenditure to 17% by 2012.

Not only has the Hong Kong Government reacted to the GFC by launching a massive development program, but it has gone much further and seriously considered what it needed to do to deliver that program in the particular circumstances that exist post the GFC.

Specific projects such as the MTR metro lines and the China Express Rail and the deep water and sewage scheme projects, which are really going to put serious technical and management demands on the contractors, have effectively been "reserved" for only those contractors which have a solid track record on such projects in Hong Kong. 'Foreign' contractors for example, have only been prequalified where they bring some particular skill and then only in joint venture with local firms.

Even safety has been considered an important element in the successful delivery of these projects and some very prominent Hong Kong contractors have been excluded from prequalification because their poor record in this regard was considered a threat to the program.

It's worth referring to another quote from Sir Donald Tsang where he talked about what needed to be done by Government to get this program underway and he said, again in his policy address, "to enhance the efficiency of the building construction industry and property development market, we endeavour to speed up the planning and approval procedures for private works."

The Government there has gone out of its way to make the program work by working with contractors.

Just touching on some of the issues that the Government has done in terms of delivery of the projects, following the GFC, bonding was very difficult to obtain.

Many of the existing sources of performance bonding and tender bonding had dried up almost completely and the cost of bonds skyrocketed. In Hong Kong contractors talked to clients (and the Government in particular) and bonding requirements were amended. In general, for Government Contracts the current bonding percentage is now 1%.

For MTR Contracts, the Contractor is usually required to price on the basis of a 10% bond within the conforming tender with priced options for a reduction in the Bonding to 5% and 3%. In recent times, MTR have been instructing the Contractor to procure a 3% bond.

In contrast in Australia, we had one Government client who, on advice from their consultants (who said that in these tough times you needed more security) increased bonding requirements from 10% to 15%.

Governments in Australia complain about a lack of competition, while at the same time they impose contractual requirements, such as these excessive bonds, that can only be met by a few firms who have the necessary balance sheet.

At a time when cash flow became very critical to contractors post the GFC, some Hong Kong Government clients allowed us to amend the normal milestone payment parameters so that we received up-front cash payments sufficient to fund the major expenditure on plant and equipment. For example on a tunnel job, typically a TBM costs \$90 million dollars, the government there allowed us to front load tenders to cover that front payment.

In Australia on the other hand we noticed the tightening of milestone payments and cash flow (again on the basis of the advice that they needed to keep the squeeze on contractors) but all it did was cause further problems.

Innovative contract solutions

In general, the Hong Kong government does not negotiate contracts.

However, whilst MTR have a large number of “hard dollar” lump sum contracts they are continually reviewing their procurement strategies internally and have recently introduced a Target Cost Contract for key challenging Projects with significant technical difficulties.

What they’re doing in this particular approach is selecting three contractors from an initial first round of submissions, (and the submission usually covers things like preliminary head office overheads and profit levels). They’re then reducing this list to 2 bidders and then they go to open hard dollar tendering from there.

This is very effective. It gives contractors an opportunity to see where they’re going before they spend a lot of money on the tender.

Dispute Resolution is another area where the Hong Government has made some really progressive moves and pretty well moved away from arbitration as a means of solving disputes. In many Government contracts there is now a built in a mediation clause and a mediation process is established early in the job.

For example some of the terms that go with it include:

- each party bears their own costs despite the final outcome of the case
- mediation compulsory for most projects.

The Issue I think we see in Australia is why we cannot make these sort of judgements on our infrastructure delivery program.

Instead we see that lawyers, accounting firms and construction advisors have created a whole industry focused on advising clients how to make contracts more onerous for contractors.

It's no surprise that most of the industry in Australia makes returns of only 1 – 2% on revenue and even at Leighton we're pleased if we achieve 3%.

In Hong Kong the local contractors are seen as a crucial element in a vibrant economy and supported accordingly.

There are numerous things that State and Federal Governments in Australia could do to speed up implementation and bring on new projects more quickly.

This includes alternative project delivery arrangements. There is a need for a whole range of delivery methodology, and the important thing I think in any of those is to select one that is appropriate to the actual project that you are trying to introduce.

Bid costs is a hardy perennial that I continue to talk about, however bid costs on major projects are out of control. On Airport Link in Brisbane, the 3 competing groups spent some \$150 million dollars just on the tendering.

People ask me what we can do about tender costs, well I believe there are a number of things Governments can do.

Governments need to reign in the demands for extras and add-ons and other peripherals that add to the cost of doing tenders. When you are doing a tender and the Government keeps asking for new ideas, this continues to add-up in cost.

Maybe the Government should limit bid options by being more prescriptive as to the finished product. In Hong Kong for example we've seen on the MTR projects a process whereby the client nominates very closely where the route of the corridor, they describe the cross section and profile of the product, they do a lot of site investigations so the tenderers have that information and they go out and ask for a D and C around that more prescriptive product.

Government's can do a lot more in terms of upfront geo-technical work. All too often we see that the job comes out and you're told that there's no information and you are responsible for whatever the ground conditions are.

One comment I will make is that I don't think the answer is re-imbusement of bid costs. I've heard it suggested that bid costs are getting so high that it is an imposition on the industry and therefore we should look at re=imbusement.

I don't think that's the answer, in my view, reimbursement will only lead to higher bid costs. If the contractor thinks he is going to get some back, odds are the contractor will decide he can spend more on the tender, so I don't think that's going to solve anything. I think the answer is in reducing the demands on tenderers at the tender stage.

Another one is better sharing of risk.

PPP's are not partnerships anymore – if they ever were. They are a process focussed on transferring risk from the Government. The PPP toll road model is dead, at least in its current form, partly because of the extent of risk of risk transfer and partly because the unending stream of extra demands placed on concessionaires have made roads so expensive that motorists just won't use them.

The other issue is sensible commercial terms.

At the end of the day everything has a cost and that cost will be passed through eventually. Aggressive and unreasonable contract conditions don't make for cheaper jobs.

Finally in summary I would say that the key element to all of this is political will.

The Hong Kong Government has cleared bureaucratic obstacles in order to accelerate a huge program of expenditure for public transport, roads and airports over the next five years.

The mega infrastructure projects scheme is focused on diverting public expenditure to drive infrastructure development, which in turn will underpin Hong Kong's economy for years to come.

The challenge and opportunity is for us to do the same here in Australia.

Thank you again for the invitation to speak.