For discussion **FCR(2001-02)52**
on 21 December 2001

ITEM FOR FINANCE COMMITTEE

CAPITAL INVESTMENT FUND
HEAD 971 - TRADELINK ELECTRONIC COMMERCE LIMITED
Subhead 101 Purchase of equity in Tradelink Electronic Commerce Limited

Members are invited to approve the continuation of the Government's investment in Tradelink Electronic Commerce Limited after taking into account the changes to be made to the Community Electronic Trading Services Agreement between the Government and Tradelink Electronic Commerce Limited.

PROBLEM

In 1992, Members approved an investment by the Government in Tradelink Electronic Commerce Limited (hereafter referred to as "Tradelink") on the basis of an agreement negotiated between the Government and Tradelink. Some changes need to be made to the agreement to ensure the provision of community electronic trading services in the medium term and to encourage the trading community to switch over to e-commerce.

PROPOSAL

2. Having considered the changes to be made to the agreement with Tradelink as described in paragraphs 6 and 8 below, the Secretary for Commerce and Industry proposes to continue with the approved Government's investment in Tradelink.

/JUSTIFICATION .....

JUSTIFICATION

3. In 1992, Government signed the Community Electronic Trading Services Agreement (hereafter referred to as "CETS Agreement") with Tradelink which –

(a) grants a seven-year franchise to Tradelink to provide certain community electronic trading services on an exclusive basis;

(b) permits Tradelink to set user charges for the exclusive services at a level sufficient for Tradelink to obtain an internal rate of return not exceeding 18% over the franchise period, although requiring Tradelink to submit initial level of charges (including projected charges over the franchise period) for each exclusive service and any cumulative annual increases thereof in excess of 7% of the last approved projected charges to the prior approval of the Government; and

(c) requires Tradelink to agree with the Government by 30 June 2002 on the continued provision of those exclusive services by Tradelink after 2003 and, if agreement cannot be reached, requires Tradelink to transfer at the end of 2003 to the Government at zero cost its assets (and associated liabilities) necessary for the provision of those services.

4. The asset-transfer arrangement set out in item (c) above is to enable the Government to take possession of the hardware and software necessary for the delivery of the services involved. The purpose is to provide the Government with maximum flexibility in arranging for the provision of those services after Tradelink's franchise expires in 2003. As a quid pro quo, Tradelink is permitted to recoup all its capital investments within the franchise period, adopting an accelerated depreciation policy as necessary instead of a normal five-year depreciation policy.

5. To introduce market competition, we plan to engage additional service providers after 2003. In addition, to ensure no disruption to service, we will continue to engage Tradelink as a service provider, but on a non-exclusive basis. In order for Tradelink to continue to provide uninterrupted service on a non-exclusive basis, Tradelink cannot transfer its assets to the Government at the end of 2003. Accordingly, we have been negotiating with Tradelink to resolve the asset-transfer provision in the CETS Agreement.

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6. We consider a fair and reasonable approach is to amend the CETS Agreement to permit Tradelink to retain the assets due to be transferred to the Government at the end of 2003, in return for Tradelink continuing to provide the exclusive services (but on a non-exclusive basis) after 2003, and reducing or freezing its charges for the exclusive services for the remaining franchise period. The reasons are as follows –

(a) since Tradelink is permitted to recoup all its capital investments from user charges within the franchise period to an extent users are paying for the assets. It will be reasonable for users to enjoy the benefit arising from the reduction or freeze in charges; and

(b) a reduction or a freeze in charges would alleviate the cost burden on users in the current economic climate.

7. To establish an objective basis to decide the fair value of the assets due to be transferred to the Government, we and Tradelink have jointly appointed an independent accountant firm to assess the value of Tradelink's relevant assets. This has now been determined to be $59.2 million.

8. On the basis of the valuation, we have negotiated with Tradelink a package of price reduction and price freeze as set out below–

(a) the charges for three existing services, namely, import and export declaration service ("TDEC"), production notification service ("PN") and certificate of origin service ("CO"), be frozen at their 2001 levels for the remaining franchise period;

(b) the charge for the existing restricted textiles export licence service ("RTEL") be reduced from $75 to $65 with effect from January 2002;

(c) the charges for the two new services to be launched in 2002, namely, dutiable commodities permit service ("DCP") and cargo manifest service ("EMAN"), be set on the basis of the normal five-year depreciation period; and

(d) preferential prices be introduced for long-term customers of DCP ($11.0 on average) and EMAN ($18.8 on average).

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9. The total revenue forgone by Tradelink under the proposed package is estimated to be $93.5 million over the remaining franchise period, broken down as follows –

Service	$ million
TDEC, CO, and PN	48.7
RTEL	13.4
DCP	13.7
EMAN	17.7
Total :	**93.5**

FINANCIAL IMPLICATIONS

10. The proposal will not result in any additional financial outlay by the Government. The Government's tentative agreement with Tradelink not to exercise the former's right to take possession of Tradelink's relevant assets upon the end of the franchise will result in the Government giving up its claim on assets which have an estimated value of $59.2 million.

BACKGROUND INFORMATION

11. On 24 July 1992, Members approved, among other things, a commitment of $187 million for the Government to take up a maximum of 48% shareholding in Tradelink in order to facilitate Tradelink to implement community electronic trading services. (Please see FCR(92-93)37 attached at Enclosure). We also informed Members of the key terms of the Government's agreement with Tradelink, including the seven-year franchise for provision of specific services, on an exclusive basis, the asset-transfer arrangement and the provision for Tradelink to obtain an internal rate of return on equity not exceeding 18% over the franchise period.

Encl.

12. In December 1992, the Government and Tradelink signed the CETS Agreement under which we granted an exclusive franchise to Tradelink for the provision of electronic data interchange (EDI) services on behalf of the Government to the trading community for six types of official trade-related documents. These services are RTEL, TDEC, CO, PN, DCP and EMAN.

13. Tradelink's franchise begins from the start of its commercial operation in 1997 and will expire on 31 December 2003. Of the six types of trade-related documents mentioned in paragraph 12 above, RTEL, TDEC, PN and CO have been rolled out in stages since 1997. DCP and EMAN will be launched in early 2002.

14. Though Tradelink is permitted to set user charges at a level sufficient for it to obtain an internal rate of return not exceeding 18% over the franchise period, Tradelink's latest forecast reveals that Tradelink's internal rate of return will be below 6%.

15. Tradelink's current and projected charges adopted in its latest forecast for the four existing services are as follows –

Service	**2001 price ($)**	**2002 price ($)**	**2003 price ($)**
RTEL	75.0	80.3	85.9
TDEC	12.9	13.9	14.9
CO	15.0	16.1	17.2
PN	16.1	17.2	18.4

16. The charges for the two services to be launched in 2002 - DCP and EMAN – have not yet been approved by the Government. Applying the accelerated depreciation policy (paragraph 4 above) to derive the charges would result in significantly inflated figures[1]. This is because the capital investments involved would have to be amortised within a period of about two years.

17. In February 2001, we consulted the Legislative Council Panel on Commerce and Industry on the post-2003 arrangement for the provision of EDI services in respect of the six services mentioned in paragraph 12 above. The Panel supported our plan in principle.

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[1] The prices for DCP and EMAN would be $76.5 and $55.0 respectively under an accelerated depreciation arrangement, as compared to $44.0 and $28.6 based on the normal five-year depreciation policy.

18. On 10 December 2001, we further consulted the Panel on the Government's tentative agreement with Tradelink as detailed in paragraph 8 above. The Panel supported the tentative agreement in principle. Some Members of the Panel suggested that the Government should further negotiate with Tradelink with a view to securing a greater price reduction by the latter. We have since approached Tradelink to follow up on this suggestion. Tradelink does not agree to improve its offer. It has pointed out that the value of the proposed package is $93.5 million whereas the jointly (Government – Tradelink) appointed independent party has assessed the value of the assets to be transferred to the Government at $59.2 million. The difference is already a concession on the part of Tradelink.

19. A Member of the Panel pointed out that under the proposed package, Tradelink would be able to tie down customers of DCP and EMAN using the long-term contract arrangement. Potential new service providers might find it commercially not viable to provide those services. This would defeat the Government's objective of introducing competition after 2003. We undertook to take this into consideration in formulating the tender arrangement for new service providers. Another Member pointed out that Tradelink had lowered its prices in the face of potential competition in the future and this had brought benefit to users. It was not unreasonable for Tradelink to provide incentives to secure customers.

Commerce and Industry Bureau
December 2001

For discussion
on 24 July 1992

FCR(92-93)37

ITEM FOR FINANCE COMMITTEE

CAPITAL INVESTMENT FUND
NEW HEAD "TRADELINK ELECTRONIC DOCUMENT SERVICES LIMITED"
HEAD 26 - CENSUS AND STATISTICS DEPARTMENT
HEAD 31 - CUSTOMS AND EXCISE DEPARTMENT
HEAD 47 - INFORMATION TECHNOLOGY SERVICES DEPARTMENT
HEAD 52 - GOVERNMENT SECRETARIAT
HEAD 181 - TRADE DEPARTMENT
Subhead 001 Salaries

Members are invited -

(a) to approve a new Head under the Capital Investment Fund with a commitment of $187 million to pay for a stake of up to 48% in Tradelink Electronic Document Services Limited (Tradelink) (paragraphs 8 and 9);

(b) to approve guarantees by Government of Tradelink's loans in proportion to Government's level of shareholding, up to a maximum of $187 million (paragraph 10);

(c) to accept the contingent liability, estimated at up to $249 million, for compensation payable to Tradelink (paragraph 11);

(d) to note the capital expenditure, estimated at $222 million spread over five years, required to equip government departments with the capabilities to handle electronic submissions (paragraph 12);

/(e) .....

(e) to note the financial implications, rising from $6,480,000 in 1992-93 to $66,950,000 in 1995-96, in recurrent expenditure for planning and implementing the project (paragraph 13); and

(f) to approve increases in the respective ceilings placed on the total notional annual mid-point salary (NAMS) value of non-directorate posts in the permanent establishment of five departments as follows -

Head/Department	Proposed increase in NAMS value for 1992-93 $
Head 26 Census and Statistics Department	1,342,440
Head 31 Customs and Excise Department	1,722,000
Head 47 Information Technology Services Department	2,474,280
Head 52 Government Secretariat	160,500
Head 181 Trade Department	2,126,520

(paragraph 14).

/Introduction .....

Introduction

Electronic Data Interchange (EDI) is the computer to computer exchange of business information in a standard format. The application of this method of instantaneously transmitting data results in improved efficiency and a significant reduction in paperwork. After many years of development, the stage is now set for the rapid global implementation of EDI to facilitate international trade.

2. In 1987, a number of major private sector organisations involved in trade formed a consortium to bring to the attention of the Government the need for Hong Kong to introduce an EDI service. This consortium is known as Tradelink Electronic Document Services Limited (Tradelink). A list of its current shareholders is at Enclosure 1.

Encl. 1

3. In order to maintain Hong Kong's position as one of the leading trading centres in the world, Tradelink concluded that it was imperative for Hong Kong to adopt this emerging international trading method. Government trade-related transactions, such as the lodging of trade declarations and applications for import and export licences, were considered obvious activities for EDI processing within the trading cycle. However, to bring this about the relevant government departments, namely the Census and Statistics, Customs and Excise, and Trade Departments, would need to be equipped with the necessary capabilities to handle electronic submissions.

4. After examining how other major trading centres have introduced EDI services, a partnership approach comprising Government and other key organisations involved in the trading cycle was identified as being the most appropriate. This approach has been adopted successfully in many European and North American trading centres.

Negotiations with Tradelink

5. On 29 October 1991, the Governor-in-Council ordered that negotiations should begin with Tradelink for it to provide a Community Electronic Trading Service (CETS) on the basis that Government would become a shareholder. Flowing from these negotiations a provisional agreement was reached with Tradelink which was accepted by the Governor-in-Council on 31 March 1992. We are also discussing this proposal with the Chinese in accordance with our undertaking to inform them of any major franchise with a validity period extending beyond 1997. These discussions are continuing.

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Encl. 2 6. The salient features of the provisional agreement are described in Enclosure 2. The main points are summarised below -

(a) Tradelink would be reorganised to accept new shareholders, with the Government initially taking a stake of about 30%. Should there be a lack of interest from other private sector organisations to become shareholders, Government would take up any unallotted new shares. In this case, Government's shareholding could increase to a maximum of 48% (paragraphs 1 and 2 of Enclosure 2);

(b) Tradelink would be given an exclusive right to handle electronic Government trade transactions for a period of seven years, to commence after the development phase has been concluded (paragraph 3 of Enclosure 2);

(c) the agreement would include a stated intention for Government to enter into a separate operating agreement with Tradelink (paragraphs 4 and 5 of Enclosure 2);

(d) there would be arrangements for Government to exercise control (paragraphs 6 to 8 of Enclosure 2);

(e) there would be specific arrangements upon the expiry of the agreement (paragraph 9 of Enclosure 2); and

(f) there would be contingency arrangements for the premature termination of the agreement (paragraphs 10 to 14 of Enclosure 2).

Proposals

7. Subject to Members' approval or acceptance of the financial implications that are described in the following paragraphs, it is proposed that the provisional agreement with Tradelink should be concluded in order that the implementation of the CETS may start as soon as possible.

/Financial .....

Financial implications

8. Government's shareholding in Tradelink could range from 30% to 48% as explained in paragraph 6(a) above. The estimated amounts to be invested and the projected dividends for a minimum of 30% and a maximum of 48% shareholding till the end of the exclusive period in money of the day terms are as set out below -

	Capital injection $ million		Dividends $ million	
	30%	48%	30%	48%
1992-1993	12	12	-	-
1993-1994	19	37	-	-
1994-1995	13	20	-	-
1995-1996	20	32	-	-
1996-1997	31	50	-	-
1997-1998	22	36	-	-
1998-1999	-	-	-	-
1999-2000	-	-	-	-
2000-2001	-	-	39	62
2001-2002	-	-	144	231
2002-2003	-	-	154	246
Total	117	187	337	539

9. Subject to Members' approval, a new Head with a commitment of $187 million will be created under the Capital Investment Fund to pay for a stake of up to 48% in Tradelink.

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10. In planning for the capital requirement a debt to equity ratio of 50:50 has been assumed. The agreement contemplates that the shareholders will, if required, guarantee loans made to the company in proportion to their respective shareholdings. As the vehicle for Government's shareholding in Tradelink would be the Financial Secretary Incorporated (FSI), which the Attorney General advises lacks the legal power to give a guarantee of the company's debts, it is proposed that the Government should agree to provide any such guarantees that FSI, as a shareholder, would otherwise be required to give. Under this arrangement, the amount of loan guarantee that would need to be provided by Government would be up to a maximum of $187 million.

11. Tradelink shareholders have invested in the development of the CETS since 1988 without any return. The implementation of the CETS would mean further substantial investments for the next five years or so before initial dividends are expected, in the year 2000. Tradelink has advised that existing and potential new shareholders would be unable to commit to further investment without provisions for compensation in the event the commercial phase cannot begin (paragraph 13 of Enclosure 2). If the commercial phase had not started within two years of the signing of the operating agreement and Government were entirely at fault, Tradelink (including Government as a shareholder) would be compensated for all equity injected plus interest at 13.5% per annum and outstanding liabilities incurred since the signing of the operating agreement. Costs incurred prior to the signing of the operating agreement would not be taken into account. Members are invited to accept this contingent liability for compensation payable to Tradelink. On the basis of the current plans, the maximum amount of compensation payable is estimated to be $249 million.

12. It is estimated that the capital expenditure needed to equip government departments with the necessary capabilities to handle electronic submissions is $222 million spread over the next five years from 1993-94 to 1997-98. When the plans are finalised, a formal proposal will be submitted to Members for consideration. At the moment, Members are only requested to note the amount of estimated capital expenditure required.

13. The capital expenditure mentioned in the preceding paragraph will result in recurrent expenditure for the departments concerned. Moreover, additional posts are required for planning and implementing the project. Members are requested to note the financial implications in respect of annually recurrent expenditure as follows -

	Personal Emoluments $ million	Other Charges $ million	Total Recurrent $ million	Number of net additional posts
1992-93	5.77	0.71	6.48	27
1993-94	9.55	20.00	29.55	37
1994-95	11.42	43.00	54.42	52
1995-96	11.42	55.53	66.95	52

14. To enable the departments to create the posts required for the necessary planning work and for implementation, it is necessary to increase the notional annual mid-point salary (NAMS) ceilings of five departments as follows -

Head/ Department	NAMS ceiling in the 1992-93 Estimates $	Proposed increase in NAMS value $	Revised 1992-93 NAMS ceiling $
Head 26 Census and Statistics Department	191,206,000	1,342,440 (4)	192,549,000*
Head 31 Customs and Excise Department	618,794,000	1,722,000 (6)	620,516,000
Head 47 Information Technology Services Department	131,000,000	2,474,280 (7)	133,475,000*
Head 52 Government Secretariat	452,316,000	160,500 (2)	452,477,000*
Head 181 Trade Department	118,935,000	2,126,520 (8)	121,062,000*

Notes - Figures in brackets denote number of posts.

* Round-up figures.

/Since .....

Since the results of the discussion leading to the finalisation of the provisional agreement with Tradelink were not available in time for inclusion of the additional posts required in the respective NAMS ceilings in the 1992-93 Estimates, Members' approval is now sought to increase the NAMS ceilings of the five departments concerned as set out above. If approved, the creation of the posts will be dealt with under delegated authority through the respective departmental establishment committees. Funds for 1992-93 have been included in Head 106 Miscellaneous Services Subhead 251 Additional commitments.

15. It should be noted that not all of the additional posts identified above will be required once the project is up and running. More than half of the posts are specifically for planning and overseeing the installation of the system. After 1996 it is envisaged that most of these posts will be progressively phased out. There is also expected to be some reduction in the staff of involved government departments once the system has been fully commissioned. This is because much of the processing, currently undertaken manually, will become computerized. It is, however, too early to quantify precisely the extent of these reductions.

(FIN L3/1/406 IV)

Enclosure 1 to FCR(92-93)37

Shareholders of Tradelink Electronic Document Services Limited

China Resources (Holdings) Co. Ltd.

Hong Kong Air Cargo Terminals Ltd.

Hongkong and Shanghai Banking Corporation Ltd.

Hong Kong Association of Freight Forwarding Agents Ltd.

Hong Kong General Chamber of Commerce

Hong Kong International Terminals Ltd.

Hong Kong Telecommunications Ltd.

Maersk (Hong Kong) Ltd.

Modern Terminals Ltd.

Standard Chartered Bank

Swire Pacific Ltd.

Salient features of the provisional agreement with Tradelink Electronic Document Services Limited

Reorganisation of Tradelink

Upon the signing of the agreement, Tradelink Electronic Document Services Limited (Tradelink) would take steps to accept Government and other major private sector organisations as shareholders. The total share of existing Tradelink shareholders would be reduced to 52%. Government would take up about 30%. The remaining 18% would be offered to new shareholders.

2. It is just possible that there will be no other organisations willing to join the consortium. In these circumstances, existing shareholders would not be obliged to provide the additional equity required. There would then be a risk that the project could not proceed. To guard against this, the provisional agreement provides that, if necessary, the Government would take up any unallotted shares. In this case, Government's shareholding could increase to a maximum of 48%.

Period of exclusivity

3. To provide initial support for the Community Electronic Trading Service (CETS), bearing in mind that a new service on the frontiers of technology is needed, Government would grant the CETS the exclusive right to handle selected electronic Government trade transactions for a period of seven years, the commercial phase. This phase would begin after the development phase when both Government and Tradelink are ready to implement the system. The length of the commercial phase is a reasonable compromise taking into account the need to provide a suitable period for the company to recoup costs without having to resort to unacceptably high level of charges and for the Government to retain the flexibility of deciding whether or not to continue with an exclusive arrangement in respect of Government trade transactions over the longer term.

Operating agreement

4. Upon the signing of the provisional agreement, Government and Tradelink would define more clearly the exclusive services to be provided by the CETS. This would take the form of an operating agreement, setting out in sufficient detail the documents to be handled, the services and functions to be carried out and when compulsory electronic submission would be introduced. Upon the signing of the operating agreement, the two agreements would run concurrently, their provisions being complementary.

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5. Government trade transactions have been chosen to be the initial focus of the CETS. While being an important element of the trade cycle, Government trade transactions form only a part of the total. At a later date, the CETS should be allowed to expand into other sectors of the trade cycle to meet the demands of the trading community. These additional services would be provided on a non-exclusive basis.

Government control

6. The agreement provides that decisions on important matters like the business of the company, the allotment of shares to new shareholders and certain transfers of shares would require the prior approval of shareholders together holding not less than 80% of the shares of the company. This means that Government's prior approval would be required in these areas as long as its shareholding remained at more than 20%.

7. From a business perspective, the boundaries of the exclusive services to be provided by Tradelink would be defined in the operating agreement. Prices to be charged for the exclusive services would be subject to the approval of the Government. Prices to be charged for non-exclusive services would not be subject to approval.

8. The agreement provides for the return to be based on equity injected. The return on equity for the entire operation of the CETS, including both exclusive and non-exclusive services, during the period of the operating agreement should be about 18% as measured by the internal rate of return (IRR). To prevent the company from amassing more equity than necessary, the return would only be earned on equity raised for bona fide current or foreseeable business requirements. In practice, an IRR of 18% would be used as the ceiling for business planning as well as approval of prices. Actual operating results would be bound to be different because planning involves the projection of a multitude of variables. At the end of the commercial phase, if the actual return were below 18%, Government would not be obliged to top up. Likewise, Government would not claw back if the return were above 18%. Tradelink's business plans would be carefully scrutinised to ensure that its projections were realistic. It is unlikely that the company would be able to achieve a return much higher than 18%.

/Expiry .....

Expiry of the agreement

9. At the end of the commercial phase, Tradelink would transfer the assets required for the operation of the exclusive services to Government or Government's nominee at zero value. Tradelink would be permitted to continue to provide the non-exclusive services if it wished. At present, it is envisaged that Government electronic trade transactions could be opened up to competition. The arrangement now proposed would provide Government with the maximum flexibility to achieve more competition if it wished to do so at a later stage.

Premature termination of the agreement

10. Tradelink has invested in the development of the CETS since 1988 without any return. Even if the provisional agreement were finalised, Tradelink would not start to earn revenue until the start of the commercial phase, which could be more than two years away. Moreover, shareholders could not expect dividends until the last few years of the commercial phase. In the circumstances, the existing Tradelink shareholders wish to have a way in which to cut losses if developments are such that it is no longer worthwhile to proceed according to the agreement.

11. Following the finalisation of the provisional agreement, the next two major milestones will be the signing of the operating agreement and the start of the commercial phase. The provisional agreement provides for premature termination at each of these milestones.

12. If, for whatever reason, an operating agreement cannot be concluded within ten months of the signing of the provisional agreement, or by such later date as may be agreed between Government and Tradelink, the agreement would be terminated and Tradelink would be wound up.

13. If the commercial phase had not started within two years of the signing of the operating agreement, either Government or Tradelink could elect to terminate the operating agreement along the lines described in paragraph 12 above. In addition, because both sides would have incurred substantial expenditure in an attempt to implement the CETS, the provisional agreement provides for compensation. Tradelink has advised that existing and potential new shareholders would be unable to commit to

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further investment without such a provision. If Government were entirely at fault, Tradelink (including Government as a shareholder) would be compensated for all equity injected plus interest at 13.5% per annum and outstanding liabilities incurred since the signing of the operating agreement. (13.5% is chosen as a compromise between normal commercial rates of return in Hong Kong and deposit interest rates.) If Tradelink were entirely at fault, Government would be compensated for 25% of the costs incurred in implementing the relevant departmental systems since the signing of the operating agreement. It should be noted that Government would in any case need to introduce improved departmental systems : 25% represents the estimated nugatory proportion of such expenditure. In practice, however, both parties are likely to be at fault if the commercial phase cannot begin. The compensation payable by each would then be based on the respective portion of blame. Costs incurred by both parties prior to the signing of the operating agreement would not be taken into account.

14. These are contingency arrangements only and at this stage neither side expect them to be invoked. Government should be able to introduce the systems required for interface with the CETS within the prescribed period. In any case, if there were no provisions on compensation in the agreement it would still be possible for one party to sue the other if it felt that the other party was to blame for the failure to introduce the commercial phase. It seems to be preferable to have limits of liability stipulated in the agreement.