LEGISLATIVE COUNCIL BRIEF

POSSIBLE MERGER OF
MTR CORPORATION LIMITED
AND
KOWLOON-CANTON RAILWAY CORPORATION

INTRODUCTION

At the meeting of the Executive Council on 24 February 2004, the Council ADVISED and the Chief Executive ORDERED that:-

(a) we should invite the MTR Corporation Limited (MTRCL) and Kowloon-Canton Railway Corporation (KCRC) to commence negotiations on a possible merger; and

(b) to ensure the community can benefit from the merger exercise, the negotiations should be conducted on the basis of the parameters set out in paragraph 14 below.

JUSTIFICATIONS

Pros and Cons of a Merger

2. We have examined the pros and cons of merging MTRCL and KCRC. Considerations include, inter alia, how the potential merger would affect the various stakeholders, whether it would allow a better use of resources and how the Government can ensure public interest is protected in terms of provision of reliable transport services at reasonable fares. Our review concludes that a merger will be of benefit to the community. The merits and demerits of a merger are examined below.

New fare-setting mechanism

3. At present, MTRCL and KCRC both enjoy fare autonomy under the MTRCL Operating Agreement and the Kowloon-Canton Railway Corporation Ordinance respectively. The railway corporations set their fares in accordance with prudent commercial principles having regard to prevailing market conditions, competition from other transport modes, and the corporations' financial objectives.

4. There continues to be strong community request for reduction of transport fares from the public and the establishment of a more objective and transparent fare adjustment process. In August 2003, the Government put forward a new fare-setting mechanism which is based on a price-cap model and allows transport fares to go up or down in light of the relevant factors and by reference to a specified formula. We are now consulting public transport operators including the two railway corporations on the details of the proposal. We see the opportunity of the merger as providing us with the necessary framework to push for a more objective and transparent fare adjustment mechanism as part of the package.

Synergies and reduction in railway fares

5. At present, the two networks of MTRCL and KCRC operate as separate entities with different operating systems including types of trains, signalling and electrification systems. A fully-integrated network will require substantial capital investment but, in the long term, could achieve more efficiency and productivity gains. Economies of scale mean that the merged corporation should also enjoy better bargaining powers vis-a-vis its suppliers. In the short term, synergies will mainly be limited to headquarters and support functions.

6. A merger will argue for the abolition of the second boarding charge. Currently, passengers have to pay a second boarding charge at the interchange point when passing through the ticket gates of the two networks. A journey that involves an interchange will therefore cost more than a journey of a similar length operated by one single operator. However, the removal of the second boarding charge will likely impact adversely on fare revenue. This calls for a comprehensive review by the railway corporations of their fare structures to rationalise the fare levels in the light of the likely synergies and the removal of the second boarding charge arising from a merger, with a view to reducing fares overall.

New railway development and financing

7. A merged corporation could reduce duplication of networks for future railway projects and facilitate early resolution of interchange arrangements for projects under planning. The merger could also maximise the utilisation of the existing railway facilities and reduce project cost and the time required for protracted negotiations between the

two corporations on project interface issues. This will be conducive to the timely delivery of railway projects and support the transport policy of using rail as the backbone of our transportation system.

8. A merged corporation will mean that there will only be one rail corporation locally that the Government can turn to for new projects, even if these were not natural extensions of the existing networks. The complementary strengths will create increased financial capacity to undertake new rail projects and place the merged corporation in a stronger financial position as cashflow from MTRCL's operations complements the capital-intensive nature of KCRC's new projects. On the other hand, where there is no competitive bidding for new projects in future, it may possibly translate into a higher project cost. This, however, is comparable to the present situation when a new project is a natural extension of an existing rail line and we foresee that there is limited scope for competitive bidding for new projects in the foreseeable future.

Competition

9. The merger will permanently remove the rail/rail competition in areas where the two networks overlap with each other. Yet the merged corporation will continue to face strong competition from other modes of public transport, notably bus services. The corporation will need to provide quality service at competitive fare levels to maintain/expand its market share. Hence, competition will still exist after the merger and prevent the merged corporation from taking a monopoly position in the provision of transport service. A carefully drafted piece of legislation which sets out clearly the rights and obligations of the merged corporation coupled with an Operating Agreement stating clearly the quality and safety requirements for the services to be provided will be key elements to ensure proper regulation of the merged entity.

Convenience to the travelling public

10. A merged railway network will provide a more integrated and convenient interchange environment through the removal of interchange ticket gates in the short term. In the long run, new rail lines can be designed to provide seamless interchange arrangements for passengers, allowing them to reap the full benefits of an integrated network.

Contingencies for service disruption

11. At present, both MTRCL and KCRC have their own contingency plans in case of service disruption or station closure. In the case of a merged corporation, contingency plans involving the use of alternative rail lines would be easier to operate. To ensure minimal disruption to the rail services which carry some three million passengers every day, proper safeguards and precautionary measures will need to be incorporated into the Operating Agreement or the governing legislation of the merged corporation to provide an effective and adequate contingency plan. The Operating Agreement should also require the merged corporation to work out a comprehensive contingency manual or procedures in conjunction with other transport operators to ensure that emergency transport relief services would be deployed quickly if necessary.

Staff and management

12. A merger will allow the streamlining of the management structure, better management of the whole railway system and better corporate management overall. Nevertheless, there will be a period of uncertainty before the merger is completed. It is crucial that the corporations manage their staff and operations well during this period to ensure that the daily operation of the rail service will be maintained.

Valuation

13. Whether the merger would be value-creating depends heavily on whether the benefits of a merger are greater than the costs. Improved business prospects by consolidating the competitive position of railways against other modes of transport and synergies and productivity gains achievable will create value. This has to be balanced against the factors affecting fare revenue.

Key Parameters for Negotiation between the Two Railway Corporations

14. A merger provides an opportunity for synergies and more effective utilisation of resources for the two corporations. It is important that the benefits so generated should be shared with the commuting public. The Administration would hence define the key parameters under which the negotiations between the two railway corporations

should be conducted. They include :

(a) adoption of a more objective and transparent fare adjustment mechanism;
(b) abolition of the second boarding charge and review of the fare structure with the objective of reducing fares;
(c) early resolution of interchange arrangements for rail projects under planning, notably the SCL;
(d) ensuring job security for the front-line staff of both corporations at the time of the merger;
(e) provision of seamless interchange arrangements in the long run; and
(f) conclusion of the negotiations by 31 August 2004.

15. Transport benefits aside, a balance would have to be struck between the public interest on one hand and the interest of minority shareholders of MTRCL on the other if the merger terms are to be acceptable to both sides.

Implementation

16. The Administration will invite the two corporations to start negotiations on a possible merger. The two corporations will be asked to give a clear undertaking in respect of all the parameters set out in paragraph 14, and to submit the outcome of their negotiations, including preliminary transaction terms and the framework of a draft integrated operating agreement with key terms on, inter alia, fare adjustment mechanism and safeguards and measures to deal with service disruption. The Administration will then decide on the way forward.

IMPLICATIONS OF THE PROPOSAL

17. Implications of a possible merger are set out at Annex.

PUBLIC CONSULTATION

18. We will brief the Legislative Council Transport and Financial

Affairs Panels and the Transport Advisory Committee on Government's decision.

PUBLICITY

19. The Government will make an announcement on 24 February 2004 to be followed by the issue of a press release. A spokesman will be available to answer media enquiries.

OTHERS

20. The subject officer is Mr Patrick Ho, Principal Assistant Secretary for the Environment, Transport and Works (Transport) (Tel no: 2189 7825).

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ANNEX

IMPLICATIONS OF THE PROPOSAL

Economic Implications

Broadly speaking, the merger, and the comprehensive restructuring it entails, should be able to improve the overall efficiency of the two railways systems taken together, through achieving larger economies of scale in the operations, attaining synergy through better interface and streamlining between the two systems, reducing overlaps in services provision and resources usage, and economising on overheads at the corporate activity and internal management levels. Strategically, the merged entity will become a pre-eminent flagship on Hong Kong's public transport system.

2. While the merged entity will become the only operator in the provision of railway services in Hong Kong, it will continue to face intense competition from other modes of public transport, chiefly from the franchised buses. Yet still, an effective means will have to be devised for overseeing and regulating such sole provision of railway services. Also, an effective system will have to be in place to uphold service standards.

3. The advent of a single railway operator may result in a single bidder for new railway projects that the Government may put out for implementation in the future. While dealing with a single bidder may simplify the Government's advocation and negotiation tasks, the terms for the new project will be determined in the absence of competition. In such circumstances, the Government will strive for the best benefits for the wider community.

4. The impact on employment will depend on the extent to which manpower resources for the railway operations could be economised consequential to the merger. It is difficult to be ascertained at this stage.

5. Should the merger pave the way later on for further privatisation through public share offer by the merged entity, it should be a positive development for Hong Kong's financial market.

Environmental Implications

6. A merged rail corporation will increase the competitiveness of rail services against other road-based transport. This will also provide room for further rationalisation of bus services and hence improvement to roadside air quality.

Basic Law and Human Rights Implications

7. The proposal is in conformity with the Basic Law, including provisions concerning human rights.

Civil Service and Financial Implications

Civil Service Implications

8. We will set up a small dedicated team of three to four people through internal redeployment for 24 to 30 months to oversee the negotiations and preparation of the necessary legislation, and ensure the smooth implementation of the merger. The Environment, Transport and Works Bureau (ETWB) will absorb the cost within its Operating Expenditure Envelope.

Financial Implications

9. If the merger can be completed by 2005-06, we expect to offer shares in the merged corporation for sale in that and subsequent years, subject to market conditions and to the requirement to maintain majority ownership by Government. The merged corporation may also require support from the Government on new projects. We will carefully consider such request having regard to the benefits delivered by such projects to the community.

Sustainability Implications

10. The proposal should in principle facilitate a better integrated rail network and give a boost to Government's drive for privatisation, which are in line with the sustainability principles of providing safe, accessible, efficient and clean transport systems and achieving a market-based economy. Appropriate control and regulation have to be put in place to

ensure the services of the merged corporation would meet public demand and align with the Government transport policy.

Environment, Transport and Works Bureau
24 February 2004