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Merging Hong Kong's Railways:
The Public Interest Perspective

Civic Exchange

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EXECUTIVE SUMMARY

A merger of the Mass Transit Railway Corporation Limited (MTRCL) and the Kowloon-Canton Railway Corporation (KCRC) would have important financial implications for the Hong Kong Special Administrative Region Government (HKSARG). Since the KCRC is wholly government owned, the HKSARG's share of a merged corporation would increase significantly, providing an opportunity for (and possibly a requirement for) it to sell additional shares. While such a prospect is appealing, there are wider economic and social ramifications of a possible merger as well. Although financial considerations play a major role in any merger, the fact that passenger rail transport is vital to the very functioning of Hong Kong makes the merger a crucial public policy concern.

Civic Exchange's aim in this report is not to propose how to construct the merger, but to emphasize that the most substantial potential benefits arising from it are in putting public transport policy on firmer tracks towards achieving rail-led transport, as is already government policy but not yet being optimized.

MTRCL Equity Holders' Perspective

A merger must meet the requirement set out in the listing of the MTRCL that equity holders receive a Weighted Average Cost Capital (WACC) plus 1% to 3%. This implies that the HKSARG must sell the KCRC to the MTRCL at a price whereby the expansion to the MTRCL's business yields WACC plus 1% to 3%. This requirement may, however, be difficult to achieve.

Firstly, the KCRC's new lines are likely to be loss making for the foreseeable future. Secondly, the Hong Kong's population growth is slowing and densities are likely to decrease somewhat. Hong Kong's old railway funding mechanism of granting the rail corporations property development rights near stations only worked in areas of extreme density (Tseung Kwan O was probably the last extension feasible under that model). The HKSARG has the choice of continuing to devise ad hoc forms of support, as it did for Penny's Bay Link (now known as Disneyland Resort Line) and West Rail, or providing some level of direct support for railway expansion (e.g., a major portion of the cost of line construction). Thirdly, property developers have a large 'landbank' near the new KCRC lines, providing potentially stiff competition for the KCRC's own prospective property developments. Finally, and perhaps most fundamentally, the HKSARG is not being proactive in promoting rail-based public transport over road passenger transport.

The MTRCL was able to list at the valuation it achieved due to the success of its government-supported property development business, in particular that for the Airport Express/Tung Chung Lines, and also because the market believed the company had autonomy in setting fares. Indeed, it appears that private equity holders in the MTRCL see the nature of their investment as one of property development as well as transport. Nonetheless, in light of opposition from other property developers and recent fluctuations in the local property market, it is unclear to what extent property will continue to play in financing new rail lines.

Urban passenger rail lines are rarely, if ever, fully self-financing. Nevertheless, railways are built because they provide vital economic and social benefits that are outside of the service provider's sources of revenue (e.g., faster and more reliable travel time, reduced road congestion, higher carrying capacity, lower environmental impacts and positive impacts on property values). As with some other forms of public infrastructure, railways require public financial support so they may attain a scale sufficient to generate the desired level of these external benefits for society as a whole.

Separating Fixed Asset Accounting Depreciation from Profitability

From a financial perspective an investment in an expanded MTRCL would look much better (indeed, may only be feasible), if the depreciation of its fixed 'assets' (rail lines) was greatly reduced. To put this in perspective consider how 'profitable' bus companies would appear, if they had to depreciate their share of the cost of the roads they use (or even bus lanes) by explicitly charging bus riders for the amortized cost of road construction and maintenance. If they had to do so, the companies would need to generate a far higher return (to offset the depreciation 'costs'). Alternatively, the 'value' of the roads might be written down to something quite low, thus obviating much of the depreciation charge. This would allow the bus companies to generate a lower return and still book acceptable profits.

There are four basic ways of doing this:

1. ***Write down the value of the assets:*** The simplest solution is to write down the value of the assets so that the assets yield a post-depreciation WACC plus 1% to 3% to private shareholders. Probably HK$30-35 billion of the KCRC's fixed assets could be written off to lower booked depreciation costs to make it easier for the MTRCL to absorb the KCRC.

2. ***Buy out MTRCL minority shareholders, restructure the assets and re-list the company:*** This method could cost HK$16 billion. Even if the HKSARG were willing, it could be difficult to convince the market of the appropriateness of a listing, followed by a 'privatisation', followed by a new listing. Finally, minority shareholders might quite rightly demand a considerable premium to sell, as is common in market capitalisations and privatisations of this type.

3. ***Government buys back the infrastructure and the MTRCL/KCRC acts as operator:*** This option would require re-negotiation of the debt structure of both corporations and the private equity part of the MTRCL. Further, it would require a scheme of control that ensures adequate maintenance to avoid poor performance.

4. ***Realising property to help railway assets:*** This option would allow the MTRCL to book a profit on the property sale to counteract a write down in its own fixed rail assets (so as to reduce the ongoing depreciation burden). Clearly, such a write down would have to be significant enough such that the on-going depreciation would be low enough for the MTRCL to handle. This approach would also allow the HKSARG to retain control of the 'landbank' of development rights and sell the investment property rights off as a real estate investment fund (REIT). However, it would take away an essential part of the funding model for new lines. Further, MTRCL minority shareholders may see their investment as having exposure to both property and a railway.

Cash Flow Drives Equity Value

Cash flow, not fixed assets value, drives equity value. With the book value of the fixed assets written down, the medium term booked profits will be higher. However, there will be a massive loss booked in the year of the write off. This loss can be counteracted by a relatively low price for the KCRC paid for by the MTRCL.

The merger could be conducted through a share swap but it is likely that the MTRCL may not have enough cash to pay for the KCRC. Hence, the HKSARG's share of the combined entity would likely rise above 75% (depending on the price paid for the KCRC) leading to a requirement for another sell down of government holdings to avoid breaching listing rules. Managing the public relations well is important so that the public can see the returns for the merger extend far beyond profit and loss statement.

By whatever means a write down in asset value might be achieved, the specific detailed requirements in the covenants of the corporations' lending documents will be important. If it is assumed that the KCRC's asset position is written down to HK$26 billion, this would allow the MTRCL, with net assets of HK$57 billion, to maintain control of the listed company. This is important, since the MTRCL has experience with listed markets and has built a solid reputation as a manager. However, even at an investment of HK$26 billion, the MTRCL's profit from 2003 represents a return on investment of only 4.6% – well below the WACC plus 1% to 3% required by shareholders. Hence, the property rights will have to remain with the rail companies.

The Broader Public Policy Context

If Hong Kong is to solve its congestion and chronically unhealthy street-level air quality, it has to do more than merely pay lip service to a rail-led transport policy. Hence, the possible merger of the MTRCL and the KCRC takes on enormous significance.

The external benefits of rail go much further than reducing congestion and air pollution. A new rail line combined with feeder bus services can obviate the need for a new road, or the substantial up-grading of an existing one. Rail-led transport significantly reduces the continuing loss of amenity land and coastline to roads and their setbacks. In addition rail provides valuable savings in travel time and makes travel times more predictable. Further, it substantially raises property values in station catchments. Rail can also handle growth much more easily.

Having two separately planned and managed rail systems has created inefficiencies. They currently do not compete in ways that add to efficiency, but rather 'compete' in ways that detract from it. With two systems, the design of the overall network is not being optimised, making it harder for rail to compete with its chief rival, franchised buses. Hence a merger, through its impetus for better design of interchange points and through fares, works toward the policy aim of promoting rail-led transport.

The competition between rail and franchised buses has implications for how the merger should be viewed. For capital intensive transport systems like rail, the average cost of service provision is largely a matter of the load factor. Since the minimum average fare on a system is ultimately set by the average cost of service, load factors are key.

Tying transport fares to a consumer price index (CPI) would be seriously misdirected. Fixed interest payments are an important part of the costs of such systems and the real value of such payments varies inversely with general price levels, not with them.

While a merger of the MTRCL and the KCRC would help to promote higher load factors, a much greater potential lies in having proper coordination between bus and rail. Hence, the best strategy to lower transport fares is a shift towards a balance of competition and coordination between bus and rail.

In considering whether this would represent a reduction in choice, it should be noted that choice is not free. The average load factors of existing modes drop when another transport mode is added. Hence their average cost of service (and ultimately the minimum fares they can charge) would go up.

In considering the right competitive environment for public transport for Hong Kong, it should be noted that the city's current transport systems are in actual fact not self-financing. Rail receives a modest but essential government-sponsored support through property development rights near stations. The property development rights support roughly 10% of the MTRCL's revenue. Buses pay no fuel duty and licensing/registration fees. They get the use of roads free of charge and even have access to their own designated 'bus lanes' without levy. Taking the non-concessionary price of diesel fuel as the base, the value of this government sponsored support amount to about 13% of the revenue of Kowloon Motor Bus in 2003. Both types of support are given in recognition of the external benefits of high capacity mass transit.

Conclusions

Merging the MTRCL and the KCRC will be good for Hong Kong. It removes certain inherent and wasteful conflicts. It should help put passenger rail in Hong Kong on a sound corporate and financial footing. This will allow rail to better play its crucial role in achieving stated transport and environmental policies.

The merger may offer opportunities for lower fares. However, this should not be the reason to support the merger. The merger is a way to strengthen rail's ability to compete more effectively against road transport. The greatest potential for lower transport fares lies in raising load factors on the heavier transport carriers, which can best be promoted by some degree of balance in coordination versus competition between rail and road transport.

Railways are essential to the proper functioning of high density urban settings. But railways are expensive and require significant public sector support to compete commercially against road transport which imposes high but largely un-priced external costs on society. Public sector support in one form or another is provided by governments around the world in recognition of the fact that for large, dense urban areas, rail provides vital external benefits to society at large that are not readily captured by the service provider.

The MTRCL should acquire the KCRC's assets so as to provide an attractive platform for future equity investors. Yet, the KCRC's relevant line assets must be acquired at a value that enables the successor to acquire a commercial return. This means the KCRC's assets should be acquired at a price that reflects their economic value rather than their construction cost. The HKSARG should ensure that there is a high level of transparency in the merger transaction and should not try to disguise true values just because they may be large.

New railway lines must be justified on transport, economic and environmental grounds; once one is justified it should be afforded appropriate public sector financial support. The proven MTR property model should be considered as one method of support, along with others (e.g., grants to cover part of the construction cost of new lines).

With a sound, financially secure single railway company, Hong Kong can have a transport future to be envied once again by other major cities.