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25th September, 2006

Clerk to the Bills Committee on Rail Merger Bill
Legislative Council Secretariat
3/F Citibank Tower, 3 Garden Road,
Central
Hong Kong

For the attention of the Clerk to the Bills Committee

I would like to offer this written deputation to LegCo which provides my independent view of the impacts of the Rail Merger Bill on the merged rail company, the Government and the taxpayer.

I am both the President of the Railway Technology Strategy Centre (RTSC) at Imperial College London and also the first Managing Director of the Hong Kong Mass Transit Railway Corporation, from 1975 to1980. The RTSC has worked with many transport operators and stakeholders in Hong Kong, including MTR, KCRC, KMB and the Transport Department. The RTSC also provides advice on policy, regulation and strategy to governments, operators and stakeholders in most of the major cities in the world. I believe my opinion may be of value.

The RTSC at Imperial College London is responsible for undertaking benchmarking analysis for 25 major metros around the world, including the MTR in Hong Kong. Our analysis, conducted continuously since 1994 has shown that the MTR has consistently out-performed most other metros on a wide range of measures. Our evidence is that the MTR is well managed, providing one of the highest levels of reliability and service quality, with high levels of efficiency and productivity at low unit costs by international standards. It has achieved this with moderate fare levels and, uniquely, without the need for subsidy from the taxpayer for either capital or operating expenditures.

This quality of service and financial performance compares favourably with all of the world's major metros for which we hold data. Key to the MTR's success has been the performance of good management which has been able to operate in a relatively stable and predictable commercial environment, crucial in an industry with long-lived capital assets (such as infrastructure and trains) which must be husbanded taking a long view. This has been possible because of autonomy from government in fare setting, alongside its unique ability to use income from property to support network development and capital enhancements, thus reducing reliance on less secure grants.

The long-term stability in incomes has allowed the MTR to manage maintenance, renewals and enhancements in assets effectively, thereby delivering sustained or indeed improving service quality to the passenger. This is in direct contrast to the experience of many metros in the world which have experienced a long-term declining quality of service due to an insufficient and poorly executed investment programme attributable to extreme year-by-year variation in government grants or government approved fares.

The graphs attached to this letter provide evidence that average MTR fares, measured on a comparable basis against other metros in the world, are moderately priced. Indeed, following three further years of inflation in Hong Kong to 2008, in combination with the agreed reduction in fare in agreement with the terms of the merger, by 2008 MTR fares are expected to be even lower by international standards. This is despite the fact that the MTR requires no operational subsidy or financial support from government.

Agreed Fare Adjustment Mechanism

An agreed Fare Adjustment Mechanism (FAM) is commonly adopted world-wide by many regulators of utilities (electricity, gas, water, as well as railways) as it allows the operator stability with which incomes are relatively predictable. This is particularly important for asset managers (such as the MTR) where investment, renewals and maintenance require a relatively assured level of income (from fares) to sustain the quality of service offered in the long term.

Importantly the FAM agreed for the merged company, takes into account both prices (CPI) and wages. It is objective and transparent, and understandable to the public who are aware of both the prices of other goods in the city and the wages they receive. International experience shows that the formula as agreed is based on good practice. The formula, by allowing an automatic annual adjustment, protects the interests of the workforce of the metro by providing income that can support fair wages, protects the legitimate interests of shareholders who receive a fair return on the capital they provide, protects the interests of taxpayers by giving strong management incentives to deliver efficiency, and protects the interests of the travelling public against unjustified fares increases.

Experience of metros elsewhere in the world has shown that if metro fares fail to keep pace with the local cost of inputs the metro uses (notably wages), the long term effect has been a decline in funds available to the metro to sustain and enhance the quality of the metro to meet the rising expectations of the public.

Whilst a FAM protects the operator against the management difficulties due to frequent and unpredictable interventions, it does not remove the ability and the duty of the regulatory body to review policies in the light of changing circumstances via a periodic review mechanism.

The review period is essential to ensure that a balanced state exists which ensures both long-term stability in the quality of the metro and value for money for the travelling public and the taxpayer.

The metro needs to manage its income to maintain and enhance its assets. A period of stability gives the metro the ability to run the business with certainly over time without the risk of interference in fare levels due to short-term political pressures. If there is political intervention in fare levels during the agreed 5 year period, managing income would become much more uncertain and management of assets increasingly difficult, and in the long term more costly.

Therefore, in order to facilitate stable business decisions by the metro to deliver sustained, long-term service quality, it is essential that the agreed formula for annual adjustments in fares is adopted automatically and in full. Without this, service quality is likely to fall as income for the metro is eroded in real terms. The actual experience of many other metros in the world has shown that falling and uncertain levels of grant or fare income have been the biggest contributor to declining service quality and ultimately, complaint from the travelling public.

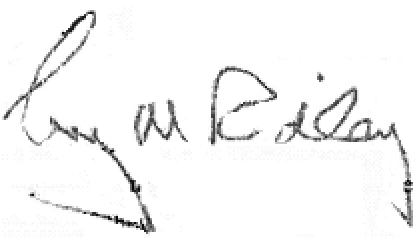
The Rail + Property Model

The control of property income adopted in Hong Kong from the outset of metro operations is part of the reason for the MTR achieving a highly successful financial performance which in turn has led to world-beating levels of performance, with reasonable fares and at little or no cost to the taxpayer. In Hong Kong, with control over property incomes, the metro is provided with the correct incentive to provide a good service as this will be reflected in strong property prices and therefore increased derived income. This model adopted in Hong Kong is unique, but it is one which many other governments view with envy and are trying to emulate by inferior means – by taxing property in the vicinity of stations. In this way Governments are seeking to capture capital gains in property prices arising from the publicly funded investment in the metro to fund the capital improvements. The Hong Kong model works well in the public interest – it is cheap to administer and the cost of capital improvements are not paid for by the taxpayer. Importantly, the property income contributes to a stable, holistic business for the metro.

The Hong Kong MTR's efficiency and financial self-sufficiency is the envy of many world cities and it is important that they be continued under the new, merged arrangements. The success lies in the fact that management has control over its business and stable finances, whilst the public interest can be properly protected through periodic review.

I would welcome the opportunity to discuss these points further with you in the future.

Yours faithfully,



Professor Tony M. Ridley

Attachment:

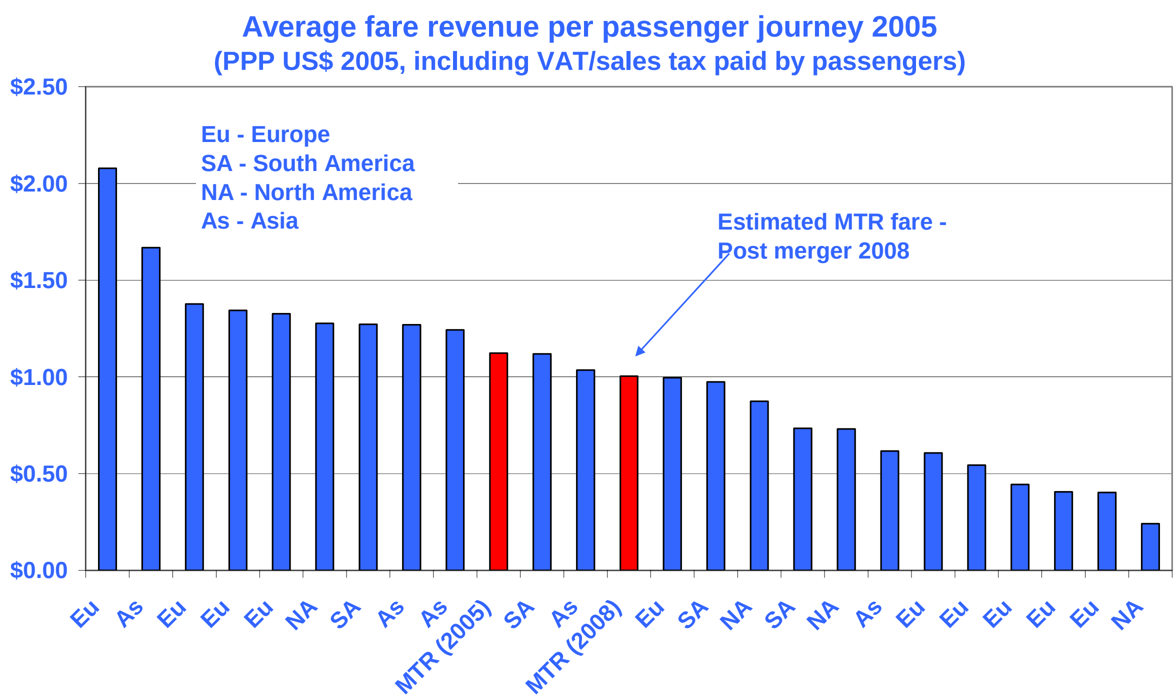
Hong Kong MTR performance and fare levels compared with other world metros.

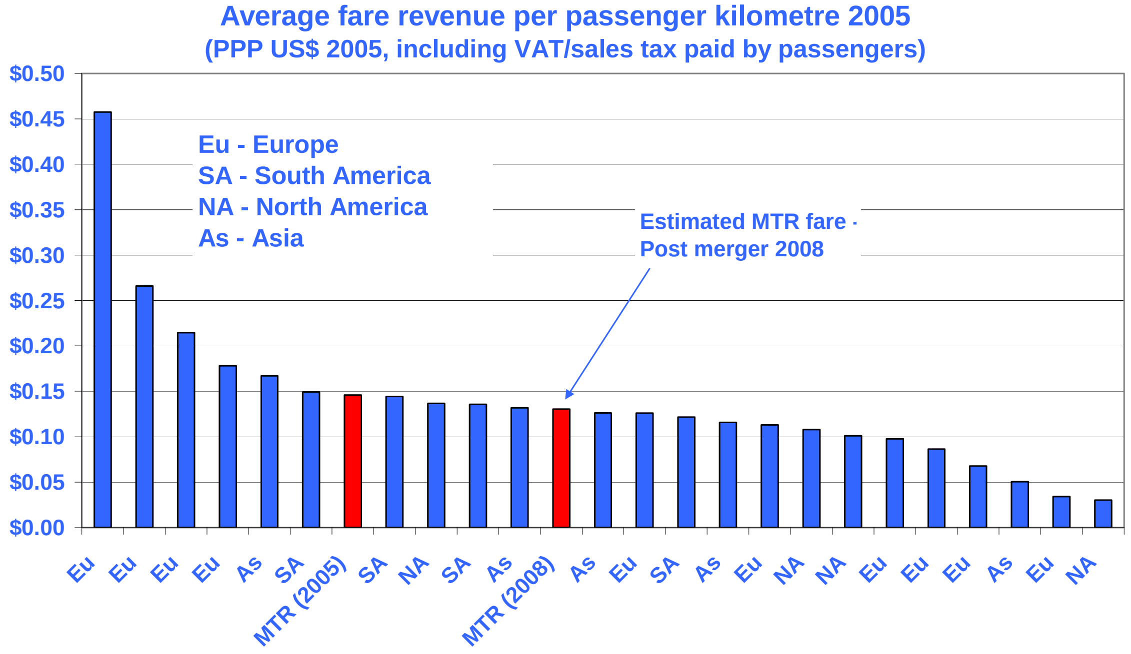
CoMET, the "Community of Metros" is a programme of international railway benchmarking. It is a consortium of twelve of the world's largest metropolitan railways (metros) - Berlin BVG, Hong Kong MTR, London Underground Ltd, Metro de Madrid, Mexico City STC, Moscow MoM, Paris Metro (RATP), Paris RER, New York City Transit, Shanghai SMOC, São Paulo MSP and Tokyo Metro - each of which transport more than half a billion passengers per year

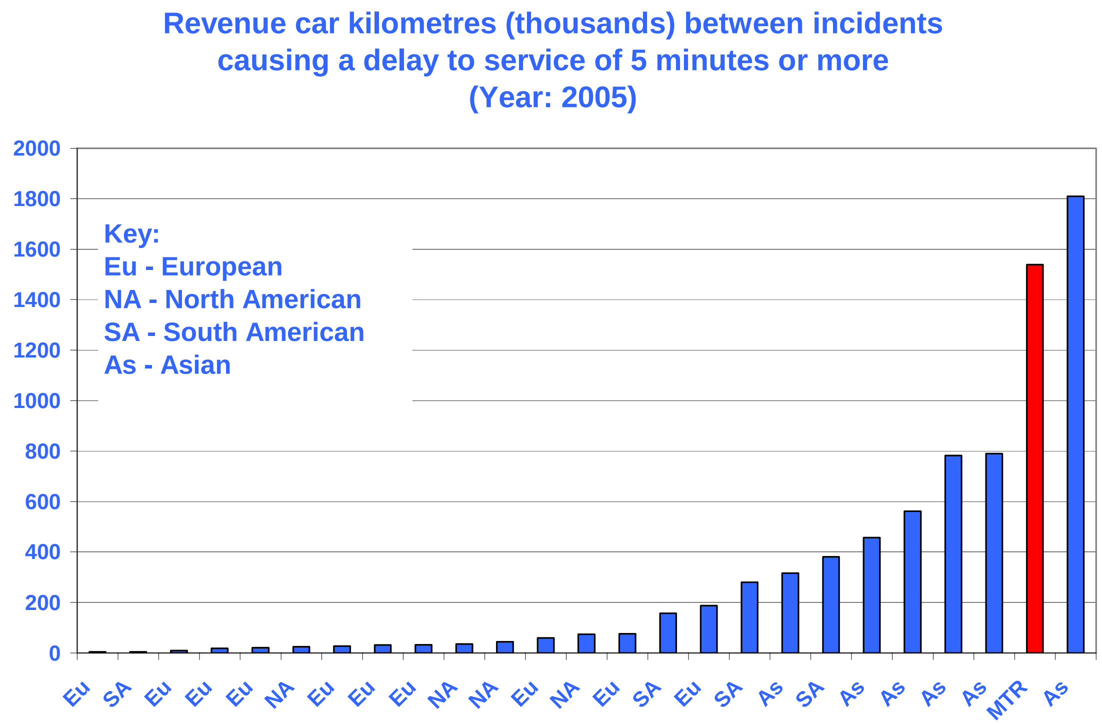
Nova is made up of a consortium of thirteen medium sized metro systems from around the world - Buenos Aires, Dublin, Glasgow, Hong Kong (KCRC), Lisbon, Montréal, Naples, Newcastle, Rio de Janeiro, Santiago de Chile, Singapore, Taipei and Toronto.

The graphs shown below in support of this letter demonstrate that MTR fares are moderate by international standards, whilst the MTR delivers the second most reliable metro service in the CoMET and Nova groups.

Average MTR fares are presented relative to other members of the CoMET and Nova metro benchmarking groups. Average fare income is adjusted to reflect the fact that other prices for goods in one city will be cheaper than another. This is achieved by using “Purchasing Power Parity (PPP)” currency exchange rates, supplied by the World Bank. These also take account of market fluctuations in exchange rates.




Average fare revenue per passenger kilometre 2005
(PPP US$ 2005, including VAT/sales tax paid by passengers)
$0.50
$0.45
$0.40
$0.35
$0.30
$0.25
$0.20
$0.15
$0.10
$0.05
$0.00
Eu - Europe
SA - South America
NA - North America
As - Asia
Estimated MTR fare - Post merger 2008
Eu Eu Eu Eu As SA MTR (2005) SA NA SA As MTR (2008) As Eu SA As Eu NA NA Eu Eu Eu As Eu NA


Revenue car kilometres (thousands) between incidents causing a delay to service of 5 minutes or more
(Year: 2005)
2000
1800
1600
1400
1200
1000
800
600
400
200
0
Key:
Eu - European
NA - North American
SA - South American
As - Asian
Eu SA Eu Eu Eu NA Eu Eu Eu NA NA Eu NA Eu SA Eu SA As SA As As As As MTR As