

ITEM FOR FINANCE COMMITTEE

CAPITAL INVESTMENT FUND

NEW HEAD “DIGITAL TRADE AND TRANSPORTATION NETWORK LIMITED”

New Subhead “Purchase of Equity in Digital Trade and Transportation Network Limited”

Members are invited to approve the creation of a new commitment of \$31.5 million under the Capital Investment Fund for the purchase of equity in Digital Trade and Transportation Network Limited.

PROBLEM

To ensure the neutrality and non-exclusivity of the Digital Trade and Transportation Network (DTTN) services launched by Digital Trade and Transportation Network Limited (DTTNCo) at the end of 2005, we need to purchase equity in DTTNCo, which is a separate corporate entity established for the delivery of the DTTN services.

PROPOSAL

2. The Secretary for Economic Development and Labour invites Members to approve the creation of a commitment of \$31.5 million under the Capital Investment Fund to acquire DTTNCo shares for the launch and subsequent operation of the DTTN System. The System seeks to improve the efficiency and reliability of data exchange along the supply chain, reduce cost and enhance Hong Kong’s logistics competitiveness.

/JUSTIFICATION

JUSTIFICATION

Nature and Economic Benefits of the DTTN System

3. The DTTN System is an information infrastructure intended to facilitate trade and enhance the efficiency and productivity of the logistics sector. It seeks to provide a neutral, open and secure e-platform to connect players along the supply chain using a set of agreed electronic business message standards and communication protocols. Its core functions are the electronic message routing and transformation services, which involve the receipt of business messages from sender, transformation of message formats and character encoding from one standard to another, and delivery of the processed messages to the recipient. As an information infrastructure and multi-compatible platform for data exchange along the supply chain, it fills a gap in the information flow by enabling connection amongst vertical and stand-alone information systems without replacing or changing them. By focusing on basic message routing and transformation functions, the DTTN System will not compete with service providers in the provision of value-added services such as solutions for multi-modal integration, distribution and transportation management, and inventory management.

4. According to the consultancy report of the Study on Development of the DTTN System (DTTN Report), the estimated tangible benefit to the industry over a 17-year period is approximately \$11.8 billion. The DTTN System is expected to generate the following major benefits –

- (a) improve the overall effectiveness and efficiency of the logistics industry as significant savings in terms of the reduction of paperwork, shorter process time, and removal of the need for data re-entry can be realized;
- (b) promote change to the traditional paper-based transaction, and adoption of information technology and e-commerce by enterprises. The value of the DTTN System will be especially significant to the small and medium sized enterprises (SMEs) which do not have the expertise and resources to develop their own system from scratch;
- (c) encourage the logistics industry to compete on high quality, high reliability and more efficient services to enhance their competitiveness in the market;
- (d) offer new business opportunities for service providers to provide value-added services and to consolidate Hong Kong's position as a logistics centre; and

/(e).....

- (e) help the logistics industry to cope with changes arising from global trade trends and developments.

Industry Participation

5. Industry participation in and acceptance of the DTTN System are imperative in ensuring its success. The Hong Kong Logistics Development Council (LOGSCOUNCIL) and its E-logistics Project Group (ELPG) have been closely involved in taking forward this initiative. In April 2003, ELPG openly invited interested parties to submit DTTN proposals. Three proposals were received. ELPG set up an Assessment Panel consisting of members with no declared conflict of interest to evaluate the proposals in the light of the guiding principles, standards and requirements enshrined in the DTTN Report. It also formed a Technical Subgroup to advise on the technical aspects of the proposals. After careful and thorough consideration, the Assessment Panel considered that the proposal from Tradelink Electronic Commerce Limited (“Tradelink”) was the closest available one to the blueprint envisaged in the DTTN Report in terms of compliance with the guiding principles, service coverage and technical standards.

6. The Government received support from the Panel on Economic Services of the Legislative Council (ES Panel) in July 2003 to enter into discussion with Tradelink immediately with a view to concluding an operating agreement with the company as a DTTN service provider. The industry continued to be fully involved, through ELPG, in the Government’s subsequent discussion with Tradelink. Guided by industry consensus and having regard to the practical needs of Hong Kong’s long-term logistics development, we concluded in August 2005 –

- (a) an Operating Agreement with DTTNCo;
- (b) a Shareholders’ Agreement with Tradelink and DTTNCo; and
- (c) a Shares Acquisition Agreement with Tradelink.

These are crucial for the scheduled launch of the DTTN services by the end of 2005.

/Operating

Operating Agreement

7. LOGSCOUNCIL considers that to ensure the neutrality of the DTTN System, it should be operated by a separate corporate entity and hence the incorporation of DTTNCo. The Operating Agreement requires DTTNCo to develop and implement the DTTN services in accordance with the service parameters, service levels, pricing model and implementation programme stipulated therein. After thorough examination, LOGSCOUNCIL endorsed the Operating Agreement in February 2005. An explanatory note on the major provisions in the Operating Agreement is at Enclosure 1.

Encl. 1

Removal of Entry Barrier

8. The Operating Agreement has been structured to ensure that entry into the DTTN services market will be free from any artificial barrier. It should be noted that –

- (a) the Operating Agreement does not grant the company any exclusive franchise. The use of DTTN services is voluntary. DTTNCo and its services are thus subject to market forces and industry scrutiny.
- (b) the guiding principles of neutrality and non-exclusivity are enshrined in the Operating Agreement as requirements to be met by DTTNCo.
- (c) DTTNCo shall grant a non-exclusive, royalty-free, non-revocable and worldwide licence to anyone who applies to use its intellectual property rights. This ensures that all standards, protocols and specifications, to the extent that the DTTNCo is the author, will be open and non-proprietary.

Shareholders' Agreement

9. The Shareholders' Agreement defines the rights and duties of shareholders of DTTNCo. It also enshrines the safeguards endorsed by LOGSCOUNCIL for upholding the neutrality and non-exclusivity of the DTTN services to be provided by DTTNCo, including shareholding structure, corporate governance, and additional safeguards over major decisions. These safeguard provisions are supported by LOGSCOUNCIL. An explanatory note on the major provisions in the Shareholders' Agreement is at Enclosure 2.

Encl. 2

/Shares

Shares Acquisition Agreement

10. The Shares Acquisition Agreement provides for the acquisition of shares in DTTNCo by the Government through the Financial Secretary Incorporated (FSI). The industry regards the DTTN as an industry-wide information infrastructure that cannot be left entirely to the private sector as a commercial endeavour at its inception. The neutrality, non-exclusivity and confidentiality of this infrastructure are critical success factors in securing industry support and participation, especially those of the SMEs. These considerations explain the incorporation of DTTNCo as a separate corporate entity to launch and operate DTTN Services, and the industry demand for Government to become a DTTNCo shareholder. The industry considers this the only effective way to ensure the neutrality of the DTTN System and the services to be provided by DTTNCo.

Consistency with Government Investment Policy

11. The Government accepts the importance of the DTTN System as an information infrastructure crucial for Hong Kong's long-term economic competitiveness. The industry has made it clear that support for this initiative hinges on government involvement.

12. Mindful of the long-standing policy to minimize Government's involvement in commercial endeavours, different options for acquiring the DTTNCo shares were explored. In parallel, the Government negotiated the terms of the Shareholders' Agreement and the Operating Agreement with Tradelink in consultation with the industry. DTTNCo was incorporated in 2004 to enable continued active development of the DTTN System with a view to a live run by the end of 2005. In line with the practice of investing in and undertaking infrastructure projects which cannot be taken forward entirely by the private sector at the inception stage, the Government has decided to purchase equity in DTTNCo in cash through the Shares Acquisition Agreement to achieve Government's involvement in DTTNCo.

13. The current proposal seeks to enable the launch of the DTTN initiative through minimum government investment in commercial endeavours. After the Government's policy objectives for the investment have been realized, the Government is prepared to sell down its shares to allow more private sector participation.

14. Pursuant to the signing of the Shares Acquisition Agreement, the FSI now holds DTTNCo shares of \$31.5 million valued at par with the settlement of the amount to be made subject to Members' approval. Despite the outstanding payment for the DTTNCo shares, FSI is treated as if it were the outright beneficial owner of the DTTNCo shares under the Shares Acquisition Agreement, and is entitled, amongst other things, to appoint directors to the DTTNCo Board and attend general meetings. FSI will need to obtain Members' funding approval within 12 months from the date when Tradelink completed transfer of the shares to FSI (i.e. from 31 August 2005). If such approval is not forthcoming, FSI will return the DTTNCo shares to Tradelink, which will have no further claim against FSI.

15. DTTNCo will need \$150 million to fund its capital investment and initial working capital requirements. At present, the total issued share capital of DTTNCo is \$108 million, of which 29.17% is held by FSI, with the balance of 70.83% held by Tradelink. The participation of other shareholders will dilute the respective shareholding of FSI and Tradelink. It is envisaged that the eventual proportion of shareholding would be 21% by FSI, 51% by Tradelink, and 28% by others.

CONTROL MECHANISM

16. The mechanism for monitoring the DTTNCo and relevant safeguard measures are detailed at Enclosure 1 and Enclosure 2. In gist, by holding some 29.17% of DTTNCo shares (with a view to dilution down to no less than 21%), FSI will have veto power over the company's major decisions under the "80% rule", and be entitled to appoint a majority (six out of 11) of DTTNCo Directors. To enhance industry participation, FSI plans to fill four of the six FSI-nominee Directors with non-official appointees, with the other two filled by government officials. The price of DTTN services will be capped during the first five years, and be monitored closely by industry and government thereafter.

FINANCIAL IMPLICATIONS

17. Subject to Members' approval, \$31.5 million will be payable to Tradelink for the acquisition of DTTNCo shares.

/PUBLIC

PUBLIC CONSULTATION

18. We consulted the ES Panel on 24 October 2005 on the proposed purchase by FSI of equity in DTTNCo. Members raised questions about the need and rationale for FSI to become a DTTNCo shareholder, and whether FSI involvement in DTTNCo might give the company an unfair advantage over prospective competitors. Subsequent to the discussion, various industry players/organisations including Hong Kong Association of Freight Forwarding and Logistics Limited, the Chamber of Hong Kong Logistics Industry, Hong Kong Container Terminal Operators Association Limited and the Hong Kong Logistics Association have written to the ES Panel in support of the proposal. A list of these industry players/organisations is at Enclosure 3.

Encl. 3

19. We consulted the ES Panel again on 23 January 2006, elaborating on the need for Government's involvement in DTTNCo as set out in paragraphs 10 to 13 above. Most of the Members who expressed views at the meeting were supportive of the proposal.

BACKGROUND INFORMATION

20. The former Port and Maritime Board commissioned a consultancy study at the end of 2000 to develop a Competitive Strategy and Master Plan for Hong Kong to maintain its position as the preferred international and regional transportation and logistics hub. The development of an electronic architecture, the DTTN System, was recommended as one of the key initiatives.

21. In June 2002, the Government commissioned the Study on Development of the DTTN System to further develop the conceptual framework of the DTTN initiative. The DTTN report confirmed the strategic importance of the DTTN initiative in enhancing Hong Kong's logistics competitiveness, and set out the guiding principles as well as technical blueprint for the development of the DTTN System. The report was endorsed by LOGSCOUNCIL in January 2003. We briefed the ES Panel on the DTTN initiative in July 2003 and obtained their support to enter into discussion with Tradelink as a prospective DTTN service provider.

DTTN Operating Agreement (OA)

1. The OA requires DTTNCo to develop and implement the DTTN services in accordance with the service parameters, service levels, pricing model and implementation programme stipulated therein.
2. The OA enshrines the following guiding principles endorsed by LOGSCOUNCIL –
 - (a) improving the overall competitiveness of Hong Kong;
 - (b) neutrality, i.e. offering a level playing field and being free from conflict of interests or sector influence;
 - (c) non-exclusivity, i.e. offering fair access to and common use by both local and international players;
 - (d) transparent, accountable, and responsible operation;
 - (e) minimum intervention in internal business processes and client relationships;
 - (f) facilitation and respect for market forces; and
 - (g) ease of access and use.
3. The OA does not grant any exclusive franchise to DTTNCo. The company is required to grant a non-exclusive, royalty free, non-revocable and worldwide licence to anyone who applies to it to use and exercise the company's intellectual property rights. This ensures that all DTTN standards, protocols and specifications, to the extent DTTNCo is the author, will be open and non-proprietary.
4. DTTNCo is required to perform and comply with standards, protocols and specifications agreed and endorsed by an advisory group, comprising representatives of different industry stakeholders, academics and professional associations, to ensure that the standards and business processes adopted would be appropriate for the Hong Kong trade and logistics communities.
5. Under the OA, DTTNCo is required to cap the charge at \$2.50 for every user-originated document successfully delivered to a recipient, which also covers functions such as encryption, decryption, verification of digital signature, transformation and acknowledgement. No price increase beyond the cap is allowed for the first five years of service launch. Thereafter, any proposed price increase beyond such cap will need to be approved by the DTTNCo Board, and in consultation with the Government.

DTTN Shareholders Agreement (SA)

1. The SA defines the rights and duties of shareholders of DTTNCo, and enshrines the safeguards endorsed by LOGSCOUNCIL for upholding the neutrality and non-exclusivity of the DTTN services to be provided by DTTNCo.

Shareholding

2. Pursuant to signing of the Shares Acquisition Agreement, the shareholding in DTTNCo is held as to approximately 29.17% by the Government (through the Financial Secretary Incorporated (FSI)), and as to 70.83% by Tradelink. The SA provides that DTTNCo may invite other parties to subscribe for new shares in the company, provided always that FSI's shareholding may not be diluted to below 21% save with the prior consent of FSI.

Corporate governance

3. The SA provides that the DTTNCo Board of Directors shall comprise 11 members, with six appointed by FSI, three by Tradelink (including the Chairman who will preside over the Board Meeting as well as the General Meeting, but has no casting vote), and the remaining two seats by other shareholders.

Safeguards over major decisions

4. Major decisions of DTTNCo shall be subject to the approval of 80% of its shareholders before they can be put to vote by ordinary or special resolution (the "80% rule"). These include acquisition, consolidation or reorganization with another business entity; expansion into other business areas, etc. With at least 21% shareholding in the DTTNCo, FSI will have veto power over these matters.
5. Tradelink is required to obtain FSI's prior consent before voting in support of any resolution in relation to issuance or purchase of shares; reduction, consolidation or conversion of share capital; etc.

**List of Industry Player/Organizations
who have reaffirmed support for the DTTN Initiative
and Government's Involvement as DTTNCo Shareholder**

1. GS1 Hong Kong
2. Mr. John HAMMOND, Shepherd of the E-logistics Project Group,
Hong Kong Logistics Development Council
3. Hong Kong Association of Freight Forwarding and Logistics Limited
4. Hong Kong CFS and Logistics Association Ltd.
5. Hong Kong Container Drayage Services Association Ltd.
6. Hong Kong Container Terminal Operators Association Limited
7. Hong Kong Logistics Association
8. Internet Professionals Association
9. The Chamber of Hong Kong Logistics Industry
10. The Chartered Institute of Logistics and Transport in Hong Kong
11. The Hong Kong Shippers' Council
12. The Institute of Purchasing & Supply of Hong Kong

(In alphabetical order)
