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Panel on Transport

**Background brief on
Kowloon-Canton Railway Corporation
Top Management's Variable Pay**

Introduction

The Panel is gravely concerned that despite the recent spate of blunders at the Kowloon-Canton Railway Corporation ("KCRC"), the Corporation's Managing Board has proposed to release the variable pay ("VP") to the eight senior executives of KCRC at this juncture when the root causes of the East Rail underframe equipment mounting problem and the management responsibility for the railway incidents are yet to be identified.

2. The Panel will review the related issues with the Administration and KCRC at its meeting on 21 March 2006. This paper provides background information on the remuneration packages of the senior executives of KCRC and summarizes the past discussions of the Council on the related subjects.

Variable pay of the senior executives of KCRC

3. Under the existing arrangement, a certain percentage of the annual income of the eight members of the Corporation's Management Committee ("MC") is withheld as contribution to the central VP pool. The Managing Board will assess the performance of the Corporation and that of the individual member of the MC during the past year to determine the amount of the VP to be allocated. According to KCRC, there are 15 criteria for assessing performances with high-targets set on the basis of the pilot scheme developed in 2004. If performances meet targets, the top team will be allocated 100% of the VP pool. If performances fall below the targets, the portion being allocated will be reduced accordingly and may even fall to zero. If performances exceed targets, the Corporation will assign additional allocation in accordance with results of the scorecard.

4. On 27 February 2006, the Managing Board accepted the assessments and recommendations of the Strategic Human Resource Committee, a subcommittee formed under the Managing Board, to release the VP to the eight members of the MC and decided to grant them a top-up VP as incentive.

5. On 2 March 2006, the MC members announced that they would retain only the original portion of the deducted salaries but would request the Managing Board to reallocate the top-up VP granted by the Corporation to all staff. The MC members recognized that the good performance of the past year owed much to the contribution of the staff. As a token of appreciation for the staff, the MC members have unanimously decided out of their own initiative to retain only the portion of their own contribution to the VP and recommend to the Managing Board to reallocate the top-up VP to the staff.

Relations between the railway incidents and the VP

6. The Managing Board was of the view that the East Rail underframe equipment cracks incident should be delinked from the VP. The Government has already indicated that an enquiry panel would be set up to investigate the incident. If it is found that anyone of the MC be held responsible, the Managing Board will take appropriate actions. The Managing Board agreed that the incident and the VP for the year 2005 should be delinked.

Consultancy study of remuneration of senior executives of statutory and other bodies in 2002

7. The Legislative Council has all along been concerned about the remunerations of senior executives of statutory bodies. It had a motion debate on this subject on 12 December 2001. There was a clear demand from Members that the Administration should look into the subject matter, with a view to drawing up some consistent and reasonable principles and guidelines to ensure that senior executives of statutory bodies were not overpaid and that their remuneration packages were in line with their comparable counterparts in the private sector. It was also necessary to enhance the transparency in the whole issue so as to ensure effective public monitoring.

8. In response to Members' concerns, the Chief Secretary for Administration (CS) announced on 4 January 2002 that the Government would commission a consultancy study on the remuneration of the senior executives of selected statutory and other bodies. The consultancy study covered 11 bodies and two of their subsidiaries. The positions under study included mainly the top three tiers of senior executives in the 11 bodies and the chief executive officers (CEOs) of the two subsidiary companies. The bodies were selected for review because all of them had to compete with the private sector for managerial staff with special experience and expertise. Many of them were required to operate under prudent commercial principles. As regards the methodology of the study, the consultant had invited about 160 private firms in Hong

Kong to participate in a survey on the remuneration of their senior executives. Data were subsequently collected from about 80 of them which agreed to take part in the study. The number of private firms chosen for comparison with each of the selected bodies varied from 10 to 25.

9. CS briefed Members on the findings and recommendations of the consultancy study on the remunerations of senior executives of selected statutory and other bodies at the Council meeting on 26 June 2002. The Panel on Public Service held two meetings on 3 July 2002 and 15 December 2003 to follow up on the related issues. The statement made by CS at the Council meeting is in **Annex A**. A summary of recommendations for remuneration levels and remuneration mix prepared by the Consultant is in **Annex B**.

Remuneration packages for the senior executives of KCRC

10. According to the Consultant, for most levels within KCRC, the level of remuneration was broadly in line with the respective comparison group median. The remuneration packages for the senior executives of KCRC in mid 2003 were as follows:

1 st tier	\$ 5.5 million
2 nd tier	\$ 4.3 million
3 rd tier	\$ 3.4 million

Remuneration mix

11. On remuneration mix, the Consultant originally made the following proposal for the senior executives of KCRC:

	Fixed pay	Variable pay
1 st tier	60%	40%
2 nd tier	70%	30%
3 rd tier	70%	30%

12. Having considered the subject matter, KCRC informed the Panel on Public Service in December 2003 that it had adopted a modified approach for the determination of remuneration mix. Based on the findings of the consultancy commissioned by the Corporation, KCRC decided that 20% VP should be adopted for the 2nd and 3rd tiers executives. Regarding the remuneration mix of the CEO post, KCRC advised that it would be determined by the Managing Board, having regard to the recommendations of the review conducted by its own consultant.

13. In discussing the related issues at the meetings of the Panel on Public Service, some members considered the high level of remuneration enjoyed by the senior executives of the selected bodies unreasonable and called for improvements. Members also cast doubt on the criteria for selecting the comparison groups for the

selected bodies, and hence, the reliability of the findings of the consultancy study commissioned by the Government.

14. On the implementation side, some members took the view that the entire review exercise would be meaningless if the governing boards or committees of the selected bodies were given the discretion to exercise flexibility in the implementation of the Consultant's recommendations. Views had also been expressed that in order to enhance the transparency and impartiality in remuneration arrangements, appointment of the remuneration committee should be made by independent parties other than the governing board or committee of a selected body. Further, there should be some objective criteria in determining the amount of VP.

Latest development

15. Members may wish to note that the Subcommittee on West Kowloon Cultural District (WKCD) Development, in its Phase II Report, recommends the establishment of a statutory body immediately to spearhead WKCD and calls for the establishment of:

- (a) a mechanism to determine the remuneration packages for senior executives of statutory bodies; and
- (b) a mechanism for disclosure of their remuneration packages to enhance transparency and facilitate monitoring by the Legislative Council and members of the public.

16. The matter would be referred to the Panel on Public Service for further consideration.

Council Business Division 1
Legislative Council Secretariat
17 March 2006

CS' statement on Remunerations of Senior Executives of Statutory and Other Bodies

Madam President,

With your permission, I would like to say a few words on the consultancy study of remunerations of senior executives of selected statutory and other bodies. We have sent a Legislative Council Brief on the subject to Members of this Council earlier today. At the outset, I hope Members would understand that most of the selected bodies are statutory organizations and some are listed bodies. These bodies are required under the relevant laws to operate independently and effectively. Financially, the bodies under review are in general not subvented by the Government and they are not under Government's direct control. Furthermore, most are required to operate on commercial principles.

Given the importance of the exercise, I would first recapitulate the background to the study, before I explain the consultant's key findings and proposals, and set out the Administration's position on the recommendations.

The Problem

Members would no doubt recall the intense public discussion particularly on the remunerations of senior executives of major statutory bodies. We had a motion debate on this subject in this Council in December last year. From these discussions, there was a clear demand for the Administration to look into this subject matter, with a view to drawing up some consistent and reasonable principles and guidelines to enable these bodies to safeguard both the propriety and general competitiveness of the remuneration arrangements for their senior executives.

First, there is general perception that senior executives of some major statutory are grossly overpaid. Second, adjustments to their remuneration packages do not appear to be in line with the prevalent pay cuts in the private sector. Last but not least, there is little transparency in this whole issue; most of these bodies do not allow for public disclosure of details of their senior executives' remuneration packages or the adjustment mechanism, making effective public monitoring difficult.

The Consultancy Study

To take account of these expressed concerns, I announced in January this year the Administration's decision to commission a consultancy study to look at remunerations of senior executives of selected bodies. In approaching this subject, the Administration has a clear position - that we must undertake the study sensibly and responsibly, and look at the remuneration policies and practices of these bodies in an objective manner.

In this regard, we have appointed a consultant pursuant to our established tendering procedures and laid down five main tasks. First, to examine whether existing remuneration arrangements of the bodies under review are in line with their comparable counterparts in the private sector. Second, the consultant should put forward his recommended remuneration packages for senior executives of each of

the bodies under review, making reference to current practices applicable to those holding comparable positions in the analogue companies. Third, the consultant should draw up some consistent and reasonable guidelines for each of the governing boards or committees of these bodies. Nevertheless, the new guidelines or recommended packages should not affect current employment contracts but take effect for new recruits or upon renewal of existing contracts only. Fourth, to enhance transparency of the remuneration arrangements of these bodies, the consultant should also come up with an effective adjustment mechanism to enable the community to monitor the long-term comparability between the remuneration packages of these bodies and their private sector counterparts. As the last study objective, the consultant's recommendations must also include a general framework for regular "disclosure" of the organizations' remuneration arrangements to the responsible Directors of Bureaux and the community in general.

I am pleased to inform this Council that we have now completed the five main tasks of the study. The study report, as distributed to Members earlier, contains a full range of findings and recommendations as required of the consultant. I would like to highlight the more pertinent findings or proposals in the report for Members' easy reference.

Study Findings and Recommendations

The study findings and recommendations are made based on the most up-to-date data collected from 80 private companies that took part in the consultant's survey in March this year. Different comparison groups were drawn up for the bodies under review. The number of private companies chosen for comparison with each of these bodies varied from ten to 25. We have decided to use the median of the collected data as a reasonable benchmark for measuring market comparability of remunerations of each tier of senior positions in the bodies under review. The consultant has also applied qualitative adjustments to the market median to reflect the unique mode of operation and prestige attached to some of the top executive positions.

In compliance with the requirements for protecting personal and privacy data, the consultant cannot disclose the current remuneration packages of senior executives serving in the bodies under review without the data subjects' consent. Nevertheless, the consultant has made general comparisons between the senior executives' existing packages with the market medians and the proposed remuneration packages respectively. The findings reveal that 70% of the CEO positions under review have their current remunerations within a range of 15% of the market medians. When the comparison is made with the consultant's proposed remuneration packages, the percentage figure becomes 60%, still presenting a large majority of the CEO reviewed. Generally speaking, similar findings apply to the second and third tier executives covered in the consultancy study.

On the remuneration mix, the consultant considers that there is a common need for these bodies to have a more significant performance-based component and a larger variable pay element under their remuneration policy.

To achieve greater consistency and objectivity in the organizations' remuneration arrangements, the consultant has proposed that each organization should designate a special committee to objectively deal with its remuneration policies and

arrangements. That committee should review the performance and remuneration particularly of the CEO, and formulate its recommendation to the relevant governing board or approving authority. Each organization should also track the remuneration levels and trends in the relevant human resource market in accordance with a prescribed and consistent methodology.

As regards disclosure arrangements, the consultant proposes the bodies under review to follow in the meantime the disclosure practice of companies listed in the Hong Kong Stock Exchange. In the longer run, as in developed countries, the consultant further proposes more complete disclosure of the pay packages at the CEO level. At other levels, these bodies should disclose the aggregate or average remuneration data for the second and third tier executives.

The Administration's Response

The Administration considers the consultant's methodology, analyses and recommendations reasonable and on the right track. But we also recognize that the consultant has, quite rightly so, exercised his professional judgment in a number of important areas. For example, after taking into account the qualitative adjustment factors attributable to the senior positions in the bodies under review, the consultant has come up with a net downward adjustment of 10% for prestige identified with two CEO positions. Another example concerns the consultant's recommended conversion factor of 1.5 for translating a variable pay into its equivalent fixed pay component. These professional judgment may contain elements of subjectivity but the Administration considers them reasonable. However, as I have just explained, neither the consultant nor the Administration can claim to have full knowledge of the competence and performance of individual post-holders. This is, however, a pertinent and essential consideration when one tries to establish the general comparability or compliance of a senior executive's remuneration with the market median or the consultant's proposed package.

Indeed, it is for this reason that we see the study recommendations as an authoritative reference tool rather than prescriptive or mandatory provisions. In other words, the recommendations are for the governing boards or committees to consider. Taking into account the qualifications, competence and performance of a particular individual, the responsible governing board or committee should decide whether and how an incumbent should justify a higher or lower pay than the market medians. Before arriving at its comprehensive decision, we would expect the governing board or committee to take into account all relevant factors including the market pay conditions and the diverse job functions and requirements for different senior positions.

Regarding the transparency or disclosure arrangements we agree that, in accordance with the general requirement to protect privacy data, we cannot disclose in the study report full packages of the senior executives. Nevertheless, we accept the consultant's recommendation that these bodies should, with immediate effect, follow the disclosure practice of companies listed in the Hong Kong Stock Exchange. This will require the disclosure of remunerations of the top five executives, showing the amount that they receive in different bands without identifying the individuals. With effect from next year, we will require these bodies to disclose the full remuneration packages of their CEO. The information should

include the CEO's base salary, allowances, variable remuneration targets, major benefits and perquisites, and any adjustments to the CEO's remuneration. At other levels, we agree that disclosure of the aggregate or average remuneration data for the second and third tier executives would suffice.

Follow-up Action

Madam President, the Administration understands and shares the community's expectation of these organizations. Insofar as remuneration policies and practices are concerned, we also expect the governing boards to be vigilant on cost control, and to conduct periodic efficiency studies as well as aim at a higher level of transparency and disclosure. At the same time, we must also recognize and pay regard to the fact that many of these organizations were established as statutory bodies with independent governing boards or committees to oversee their management and operations. It would not be appropriate for the Administration to prescribe or mandate the salary levels for their senior staff on behalf of the governing boards. After all, the governing boards know much better than we do as to the qualification, experience, competence and performance of their top executives, and hence would be able to make fair and proper judgment on remuneration issues pertaining to the respective organizations. I would like to reiterate that paying due respect to the rule of law the Government has no intention to interfere with existing contractual arrangements. Any new guidelines or recommended packages should not affect current employment contracts but take effect for new recruits or upon renewal of existing contracts only.

Notwithstanding the above, Madam president, we have invited the respective governing boards of these bodies to carefully study the consultant's recommendations and inform their responsible Director of Bureaux the outcome of their deliberations and the implementation programme in six months. We will establish a mechanism to require each of these bodies to report annually to its Director of Bureau the detailed remuneration arrangements for each of the three layers of its senior executives, the compliance of the remuneration arrangements with the established principles set out in the consultancy report, any deviations from the principles with justifications, together with a full list of comparison companies used in coming up with the remuneration packages. The Director of Bureau should also be kept informed whenever adjustments to the remuneration policy or packages are made. We believe such arrangements strike a proper balance between the need to preserve the independent and effective management of the statutory and other bodies by the governing boards and public expectation of these bodies to achieve greater transparency and accountability.

In the meantime, the Administration stands ready to brief the relevant Panel of the Council on the detailed findings and recommendations of the consultancy study.

Thank you, Madam President.

End/Wednesday, June 26, 2002

Table 2: Summary of Recommendations: Remuneration Level and Mix

	HKMA	SFC	MPFA	MTRCL	KCRC	AAHK	URA	STP	HKTB	TDC
Tier 1: Chief Executive Officer or Equivalent										
Comparison Group Median	9,558	9,558	5,292	6,934	5,941	5,941	4,920	3,875	3,800	5,084
Qualitative Factor	-10%	-10%	0%	0%	0%	0%	0%	0%	0%	0%
Market Mix (% variable)	64%	67%	36%	48%	40%	40%	40%	46%	37%	27%
Proposed Mix (% variable)	20%	15%	15%	40%	40%	40%	25%	25%	20%	25%
Total Remuneration (at Proposed Mix)	7,250	7,033	4,902	6,721	5,941	5,941	4,652	3,579	3,569	5,047
Second Tier Executives										
Comparison Group Median	5,011	4,734	3,654	4,074	4,074	3,299	2,963	2,094	2,157	3,075
Qualitative Factor	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Market Mix (% variable)	42%	46%	34%	33%	33%	32%	32%	20%	16%	26%
Proposed Mix (% variable)	15%	15%	15%	30%	30%	30%	20%	20%	15%	20%
Total Remuneration (at Proposed Mix)	4,536	4,219	3,410	4,029	4,029	3,275	2,836	2,094	2,149	3,009
Third Tier Executives										
Comparison Group Median	3,280	2,734	2,469	N/A.	3,299	N/A.	2,093	1,565	1,472	2,184
Qualitative Factor	0%	0%	0%	N/A.	0%	N/A.	0%	0%	0%	0%
Market Mix (% variable)	45%	34%	29%	N/A.	32%	N/A.	20%	21%	26%	20%
Proposed Mix (% variable)	15%	15%	15%	N/A.	30%	N/A.	20%	20%	15%	20%
Total Remuneration (at Proposed Mix)	2,935	2,552	2,348	N/A.	3,275	N/A.	2,093	1,559	1,415	2,184

Notes: (1) Total Remuneration consists of fixed and variable remuneration in the proportion indicated by proposed mix.

(2) Second and third tier remuneration levels may vary within a range of 25% around the total remuneration indicated.

(3) Further adjustment may be required, at the discretion of governing board or approving authority, for jobholders serving as Chairman in addition to CEO.

(4) Total remuneration (at Proposed Mix) based on the conversion factor of 1.5.