

LEGISLATIVE COUNCIL BRIEF

Tate's Cairn Tunnel Ordinance
(Chapter 393)

Application for Toll Increase by Tate's Cairn Tunnel Company Limited

INTRODUCTION

At the meeting of the Executive Council on 9 September 2008, the Council ADVISED and the Chief Executive ORDERED that the Tate's Cairn Tunnel Company Limited (TCTC)'s application for toll increase should be approved, and that the new tolls should take effect from 30 November 2008.

JUSTIFICATIONS

Background

2. TCTC was granted a franchise under the Tate's Cairn Tunnel Ordinance (Cap. 393, the Ordinance) to build and operate the Tate's Cairn Tunnel for 30 years starting from July 1988, inclusive of the construction period. The tunnel was built at a cost of \$1.96 billion and was opened to traffic in June 1991. The franchise granted to TCTC will expire in July 2018.

3. Section 36(3) of the Ordinance provides that the tolls specified in the Schedule to the Ordinance may be varied by agreement between the Chief Executive-in-Council and the TCTC. If an agreement cannot be reached, either party may resort to arbitration. The Ordinance has not set out the criteria for determining toll adjustments. It only stipulates that if the matter is submitted for arbitration, the arbitrator shall be guided by the need to ensure that TCTC is reasonably but not excessively remunerated for its obligations under the Ordinance. A copy of section 36 of the Ordinance is at **Annex A**.

TCTC's Application for Toll Increase

4. So far, the Tate's Cairn Tunnel has had four toll increases that came into effect in May 1995, November 1996, January 2000 and August 2005 respectively. TCTC applied for its fifth toll increase in December 2006, proposing increases ranging from 13% to 28% for different vehicle types. The Administration repeatedly urged TCTC to consider the timing and level of increase in the light of public acceptability, and TCTC agreed in July 2008 to revise the application with increases ranging from 9% to 20%. Details of the original and revised proposals are set out below –

	Motor-cycles	Private cars & taxis	Light buses and light goods vehicles	Medium and heavy goods vehicles	Single-decker buses	Double-decker buses	Extra axle
Existing Tolls	\$10	\$12	\$18	\$23	\$24	\$26	\$15
Original Proposed Tolls	\$12	\$15	\$23	\$26	\$30	\$33	\$19
Increase %	20%	25%	28%	13%	25%	27%	27%
Revised Proposed Tolls	\$11	\$14	\$21	\$25	\$28	\$31	\$18
Increase %	10%	17%	17%	9%	17%	19%	20%

TCTC's Financial Position

5. By the end of June 2007, TCTC accumulated losses of \$53 million, representing a shortfall of \$2,343 million as compared with the expected cumulative profit of \$2,290 million in the base case projection made by TCTC in its franchise bid of 1988¹. The difference between the actual profit/losses of TCTC and base case projections over the years is set out below.

¹ The base case projection refers to the traffic, toll revenue and profit/loss projections included in TCTC's franchise bid, on which the expected IRR of 13.02% was derived.

Profit & Loss (in \$million)			
Year²	Base Case Projection (A)	Actual Profit/Losses (B)	Difference (B-A)
1991/92	(149)	(176)	(26)
1992/93	(148)	(159)	(11)
1993/94	(147)	(147)	0
1994/95	(69)	(143)	(74)
1995/96	(56)	(94)	(38)
1996/97	41	(71)	(112)
1997/98	66	(43)	(109)
1998/99	88	(41)	(129)
1999/2000	194	(10)	(204)
2000/01	212	18	(194)
2001/02	265	92	(173)
2002/03	356	103	(253)
Deferred tax adjustment³	-	120	120
2003/04	371	97	(273)
2004/05	372	112	(260)
2005/06	448	141	(307)
2006/07	447	146	(301)
Cumulative	2,290	(53)	(2,343)

6. TCTC started to make an operating profit in 2000/01. It repaid its bank loan in October 2004, and thereafter in 2004/05, repaid the shareholders' loan. According to TCTC, at the current toll levels, it would be able to wipe off the accumulated loss by 2007/08, with an accumulated profit of \$103 million at the end of the year. TCTC also forecasts that it will start to pay dividends in 2008/09.

² TCTC's financial year is from 1 July to 30 June of the following year.

³ The deferred tax adjustment was a result of the adoption of a revised accounting standard.

Internal Rate of Return

7. In planning its franchise bid in 1988, TCTC assumed that the project would generate an Internal Rate of Return (IRR) of 13.02% over the 30-year franchise period. If no toll increase is to be made until the end of the franchise, TCTC will only achieve an IRR of 5.81%. If only the current toll increase application and no other is approved, TCTC will achieve an IRR of 6.11%. If, however, four further increases are made after the current one, TCTC will be able to achieve an IRR of 8.33%.

Reasons for Financial Underperformance

8. TCTC considers that the financial underperformance has been caused by lower-than-expected toll revenue because the traffic volume through the tunnel has been lower than the traffic forecast in the franchise bid. A comparison of its base case forecast in the franchise bid and the actual traffic throughput is shown below –

Daily Average Traffic Volume (in thousands)			
Year⁴	Base Case Forecast	Actual	Difference
1991/92	64.7	56.6	-12%
1992/93	69.2	68.7	-1%
1993/94	73.8	79.6	+8%
1994/95⁵	78.3	80.7	+3%
1995/96⁵	82.9	75.5	-9%
1996/97	87.0	71.9	-17%
1997/98	90.6	69.5	-23%
1998/99	93.1	62.5	-33%
1999/2000	93.8	64.1	-32%
2000/01	93.8	64.0	-32%
2001/02	93.8	63.5	-32%
2002/03	93.8	61.5	-34%
2003/04	93.8	61.2	-35%
2004/05	93.8	60.0	-36%
2005/06	93.8	55.3	-41%
2006/07	93.8	55.6	-41%

9. TCTC attributes the lower-than-expected toll revenue to the following: -

⁴ TCTC's financial year is from 1 July to 30 June of the following year.

⁵ Two toll increases took effect on 1 May 1995 and 1 November 1996 respectively.

- (a) increasing toll disparity between the Lion Rock Tunnel and Tate's Cairn Tunnel;
- (b) relocation of the airport to Chek Lap Kok;
- (c) relocation of industrial/manufacturing activities to the Mainland;
- (d) prolonged economic difficulties between 1998/99 and 2003/04; and
- (e) more choices of transportation modes and alternative roads.

Administration's Assessment

(A) Guiding Principle – Reasonable but not Excessive Remuneration

10. In considering TCTC's Base Toll Proposal in 1988, we agreed to the initial tolls but gave no undertaking in respect of subsequent adjustments. Neither was there any agreement on a targeted or expected IRR. However, based on the Base Toll Proposal that accompanied its franchise bid, we understand TCTC expected that it would achieve an IRR of 13.02% over the 30-year franchise period. This is in fact the lowest among the four Build-Operate-Transfer tunnels in Hong Kong. The Route 3 (Country Park Section) aims at a targeted IRR of 15.18%, while the targets for the Eastern Harbour Crossing (EHC) and the Western Harbour Crossing are both 16.5%. The initial toll and TCTC's expectation on subsequent toll levels in its Base Toll Proposal are as follows –

Category of Vehicles	Initial Toll	TCTC's Own Expectations on Subsequent Toll Levels				
	July 1991	July 1994	July 1996	July 1999	July 2002	July 2005
Private cars, taxis and motorcycles	\$4	\$6	\$8	\$10	\$13	\$15
Light buses and light goods vehicles	\$7	\$10	\$14	\$17	\$23	\$26
Medium and heavy goods vehicles and buses	\$8	\$12	\$16	\$20	\$26	\$30
Extra axle	\$5	\$8	\$10	\$13	\$16	\$20

(B) Traffic Implications

11. Currently, the Tate's Cairn Tunnel has an average daily throughput of 56,400 vehicles, against a design capacity of 78,500. Based on its revised proposed toll increases, TCTC estimated that about 700 and 200 vehicles would be diverted to the Lion Rock Tunnel (LRT) and Tai Po Road (TPR) respectively per day. However, it should be noted that Route 8 between Cheung Sha Wan and Shatin was commissioned in March this year to provide a further alternative to LRT and TPR⁶. Our assessment is therefore that the traffic impact on the road system linking Shatin and Kowloon is unlikely to be significant.

(C) Arbitration

12. As mentioned above, if an agreement on the toll increase cannot be reached between the Government and TCTC, either party may resort to arbitration. TCTC may therefore resort to arbitration if its application for the toll increase is rejected. In this connection, our experiences in handling the two toll increase applications of the EHC and the subsequent arbitrations may be used as reference, since the EHC has a similar toll adjustment and arbitration mechanism. In both arbitrations, the EHC franchisee was allowed to raise its tolls substantively⁷ so as to achieve an IRR of 15-17% over the life of the franchise. Besides, any arbitration proceedings will mean cost implications to the Government.

IMPLICATIONS OF THE PROPOSAL

13. The financial and economic implications of the proposed toll increase are in **Annex B**. The proposed increase is in conformity with the Basic Law, including the provisions concerning human rights. It has no environmental, sustainability, productivity or civil service implications.

⁶ The daily throughput of Lion Rock Tunnel in July 2008 was 82,200 vehicles, compared to 90,900 vehicles in January 2008. The daily throughput of Tai Po Road was 27,200 in April 2008, compared to 32,400 in January 2008. These figures indicate the diversion effect of Route 8.

⁷ The tolls at EHC were increased by 50% to 60% in January 1998 and 63% to 67% in May 2005.

PUBLIC CONSULTATION

14. TCTC's original application was discussed at the Legislative Council Panel on Transport's meeting on 25 April 2008. Panel Members expressed objection to the high level of increase sought by TCTC, and passed a motion urging the Government to reject the application. In addition, the Panel suggested that Government and TCTC should enter into discussion on possible measures including extension of franchise in exchange for lower tolls. After the Panel meeting, the Administration continued to urge TCTC to consider its toll increase proposal in the light of public acceptability, and TCTC agreed in July 2008 to revise the application with the increases ranging from 9% to 20%. In parallel, the Administration has commenced discussion with TCTC to explore the option of franchise extension.

15. The Transport Advisory Committee (TAC) was consulted on TCTC's application in July 2008. Taking into account all relevant factors⁸, the TAC advised that TCTC's current application was justified. TAC considered that with the current application and another four future toll increases set out in TCTC's application, an IRR of 8.33% would represent a reasonable but not excessive return. Nevertheless, TAC considered that this did not mean that the four projected increases should be accepted and that each application had to be considered in the light of the then prevailing circumstances. TAC's detailed advice is set out in its letter to the Secretary for Transport and Housing at **Annex C**.

PUBLICITY

16. A press release was issued on 9 September 2008 on the decision of the Chief Executive-in-Council.

ENQUIRIES

17. Any enquiries concerning this Brief can be directed to Miss Rosanna Law, Principal Assistant Secretary for Transport and Housing, at 2189 2182.

Transport and Housing Bureau
September 2008

⁸ Including interpretation of what amounts to "reasonable but not excessive remuneration", financial position of TCTC, traffic impact of the proposed toll increase and public acceptability.

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List of Annexes

- Annex A - Section 36 of the Tate's Cairn Tunnel Ordinance (Cap. 393)
- Annex B - Implications of TCTC's Proposed Toll Increase
- Annex C - TAC's Advice

Chapter: 393	Title: TATE'S CAIRN TUNNEL ORDINANCE	Gazette Number:
Section: 36	Heading: Company to charge approved tolls for use of tunnel	Version Date: 30/06/1997

PART VIII

COLLECTION OF TOLLS

(1) Subject to this Ordinance, the Company may demand and collect tolls in respect of the passage of motor vehicles through the tunnel.

(2) The tolls that may be collected under subsection (1) shall be those specified in the Schedule.

(3) The tolls specified in the Schedule may be varied-

- (a) by agreement between the Governor in Council and the Company; or
- (b) in default of agreement by submission of the question of the variation of tolls to arbitration under the Arbitration Ordinance (Cap 341) by either the Governor in Council or the Company.

(4) On a submission to arbitration under subsection (3), the arbitrators shall be guided by the need to ensure that the carrying out by the Company of its obligations, or the exercise of its rights, under this Ordinance is reasonably but not excessively remunerative to the Company, having regard to-

- (a) any material change in the economic conditions of Hong Kong since the enactment of this Ordinance or, as the case may be, since tolls were last determined under this section;
- (b) the dismissal of any appeal by the Company made under section 53;
- (c) any material change in any other circumstances affecting the exercise by the Company of its rights under the franchise;
- (d) the effect of the introduction of, or alteration in, any tax or levy imposed on the use of the tunnel;
- (e) the project agreement; and
- (f) any other relevant matter.

(5) In determining for the purposes of subsection (4) whether the carrying out by the Company of its obligations, or the exercise of its rights has been reasonably but not excessively remunerative to the Company, the arbitrators shall, if there has been any failure by a guarantor under the further guarantee agreement to comply with the terms of that agreement, deem the Company to be in the financial position it would have been in had the further guarantee agreement been honoured, and subject to this subsection nothing in that subsection shall be deemed to render such failure a relevant matter which the arbitrators may take into consideration.

(6) Where under subsection (3)-

(a) the Governor in Council and the Company agree to a variation of the tolls; or

(b) in an award pursuant to a submission to arbitration it is determined that the tolls should be varied,

the tolls specified in the Schedule shall be varied in compliance with such agreement or award, as the case may be.

(7) The Commissioner shall, by notice in the Gazette, as soon as is practicable after such agreement or award as is referred to in subsection (6), amend the Schedule.

(Enacted 1988)

Implications of TCTC's Proposed Toll Increase

Financial Implications

With approval by Chief Executive-in-Council of TCTC's proposed toll increase, the estimated additional royalty revenue to be paid to the Government will be about \$1.4 million, these estimates have taken into account the diversionary impact of the toll increase on existing traffic, on the basis of the estimated traffic flow using Tate's Cairn Tunnel in 2008-09. TCTC's annual total royalty payment to the Government will be increased to \$18.5 million as a result.

Economic Implications

2. Given that tolls for using the Tate's Cairn Tunnel constitute an insignificant proportion of average household spending, TCTC's proposed toll increase would have a minimal lifting effect on the Consumer Price Index.



25 August 2008

Ms Eva Cheng, JP
Secretary for Transport and Housing
2/F, Main and East Wings
Central Government Offices
Lower Albert Road, Central

Dear Ms Cheng,

**Application for Toll Increase
by Tate's Cairn Tunnel Company Limited**

The Transport Advisory Committee has examined in detail the toll increase application submitted by the Tate's Cairn Tunnel Company Limited (TCTC). This letter sets out the Committee's views and advice to the Chief Executive-in-Council.

Members noted the last toll increase was implemented in August 2005. TCTC originally applied for toll increases ranging from 13% to 28% for different vehicle types in December 2006. After careful consideration, TCTC later submitted a revised application with lower toll increases ranging from 9% to 20% for different vehicle types.

In considering the revised application, Members took the view that all relevant factors and circumstances should be taken into account. These factors include the financial position of TCTC, what constituted "reasonable but not excessive remuneration", the prevailing economic conditions, public acceptability and the traffic implications that might be brought about by the proposed toll increase.

In submitting its franchise bid in January 1988, TCTC had assumed that the project, with construction cost of about \$1,962 million, would generate an Internal Rate of Return (IRR) of 13.02% over the 30-year franchise period. Members were informed that the projected IRR of 13.02% was not an agreed figure. Nonetheless, it was the lowest targeted IRR amongst the four Build-Operate-Transfer tunnels in Hong Kong.

Members noted that based on the current forecast, if the current toll increase application was acceded to, as well as four subsequent similar applications in the remaining 10-year franchise period, TCTC would achieve an IRR of 8.33%. If only the current toll increase application and no other was acceded to during the remainder of the franchise, TCTC would achieve an IRR of 6.11%. If there is no toll increase for the rest of the franchise period, TCTC would achieve an IRR of 5.81%. Members were of the view that for such a large-scale and long-term infrastructure investment, an IRR of 8.33% would not be unreasonable nor excessive. We hasten to add this review is by no means indicative of our views in respect of any future toll increase application nor that an IRR of 8.33% is acceptable for future applications. Each application must be considered in the light of the then prevailing circumstances.

Members were informed of the financial performance of TCTC. Its bank loan and shareholders' loan have been repaid. It is expected to write off the accumulated loss by 2007/08 and the cumulative return will become one of profit. When compared with a similar infrastructure project, namely, the Eastern Harbour Crossing, which was commissioned around the same time as TCTC, the company's financial position was substantially less favourable. TCTC explained that this was largely because of the lower than expected traffic volume through the tunnel as compared to that envisaged in the franchise bid. TCTC attributed this situation to a number of factors, including increasing toll disparity between Lion Rock Tunnel and Tate's Cairn Tunnel, relocation of the airport, a wider choice in public transportation modes and roads for commuters and migration of industrial/manufacturing activities to the Mainland. Whilst the return achieved in other franchise is strictly irrelevant, these factors nonetheless are relevant to why the actual volume of traffic flow is what it is.

From the traffic management perspective, Members noted that with the proposed toll increase, about 700 and 200 vehicles would be diverted to Lion Rock Tunnel and Tai Po Road respectively each day. Nevertheless, Members noted that the section between Cheung Sha Wan and Shatin of Route 8 was commissioned in March this year and provided a further alternative to Lion Rock Tunnel and Tai Po Road. As such, the traffic impact on the road system linking Shatin and Kowloon would unlikely be significant.

Public acceptability and the possible financial impact on road users are factors which have to be taken into account. One Member commented that the high percentage increase would likely attract adverse reactions from the public. This is not an invalid concern given the percentage increase figure was between 9% and 20%.

Members noted that the tunnel was mainly used by private cars and taxis (about 70%), to be followed by goods vehicles (about 20%). Buses constituted about 8% among all vehicle types. The percentage in toll increase is at the low end for the majority of the users. The expenditure on toll for buses is less than 1% of its operating costs. Importantly, commuters have a choice of alternate routes as well as alternative transport mode.

Having regard to all these considerations, Members are of the view that a balance had to be struck between public acceptability and TCTC's entitlement to a reasonable but not excessive remuneration.

Members were aware of the right of TCTC to resort to arbitration. If the toll increase is considered to be generally justifiable, it would be much better from an overall perspective to reach an agreement with TCTC than to incur public spending by way of legal costs in resolving such differences through contentious proceedings.

After weighing all the above factors, the Committee has concluded that TCTC's current application for toll increase is justified. I should be grateful if you would convey this Committee's advice to the Chief Executive-in-Council.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Teresa Cheng', with a horizontal line underneath.

(Ms Teresa Cheng)
Chairman

Transport Advisory Committee