

**For discussion
on 25 February 2011**

LEGISLATIVE COUNCIL PANEL ON TRANSPORT

The New Hong Kong Tunnel Company Limited's Application for Toll Increase

PURPOSE

This paper seeks Members' views on an application from the New Hong Kong Tunnel Company Limited (NHKTC) to increase the tolls of the Eastern Harbour Crossing (EHC).

BACKGROUND

2. NHKTC was granted a 30-year franchise to build and operate the EHC commencing 7 August 1986. The EHC was opened to traffic on 21 September 1989.

3. Section 55(3)(a) of the EHC Ordinance (Cap. 215) provides that the tolls specified in the Schedule to the Ordinance may be varied by agreement between the Chief Executive-in-Council and the tunnel company. If an agreement cannot be reached, either side may resort to arbitration under the Arbitration Ordinance (Cap. 341). While the EHC Ordinance does not set out the criteria for determining toll adjustments, it stipulates that if the matter is submitted for arbitration, the arbitrators shall be guided by the need to ensure that the company is reasonably but not excessively remunerated for its obligations under the EHC Ordinance. A copy of Section 55 of the EHC Ordinance is at **Annex A**.

Previous Toll Increase Applications

4. In May 1995, NHKTC submitted for the first time an application for a \$10 or 100% toll increase for private cars and similar percentage increases for other types of vehicles. The then Governor-in-Council rejected the application in October 1995. NHKTC resorted to arbitration in January 1996 and the arbitration hearing took place in February 1997.

5. A Final Interim Award was made by the Arbitrator in April 1997 which specified that the toll for private cars and taxis should be increased by \$5 (from \$10 to \$15) with corresponding increases for other types of vehicles with effect from 1 January 1998. The Arbitrator also ruled that a reasonable but not excessive remuneration to NHKTC fell within a range of 15% to 17% Internal Rate of Return (IRR). The Arbitrator believed that it was desirable to have small regular increases rather than fewer more drastic increases. Hence, he anticipated that further \$5 increases at approximately five-yearly intervals thereafter would prove necessary assuming that the projected traffic flows which were agreed by the experts then proved to be reasonably accurate.

6. In September 2002, NHKTC submitted its application for a second toll increase of \$5 (from \$15 to \$20) for private cars with corresponding increases for other vehicles on 1 January 2003. In July 2003, the Chief Executive-in-Council rejected NHKTC's application. NHKTC resorted to arbitration in August 2003 and the arbitration hearing took place in September 2004.

7. In January 2005, the Arbitrators made an Award which specified that the toll for private cars and taxis should be increased by \$10 (from \$15 to \$25) with corresponding increases for other vehicles on 1 May 2005. After further discussions between the Government and NHKTC, the company agreed to defer the toll increase for empty taxis to 1 July 2005 and the toll increase for light buses to 1 October 2005.

8. In the 2005 arbitration, the Arbitrators considered that the changes in the economic conditions of Hong Kong since the tolls were last determined in the 1997 Arbitration were not material and were not sufficient to affect the overall level of reasonable but not excessive remuneration determined over the life of the franchise. They also considered that while some drastic and prolonged changes in economic circumstances during the lifetime of the project would require a review, it was neither in the interests of the parties nor the public if tolls were continually reviewed and adjusted during less than material fluctuations in the economy over the 30-year franchise. The Arbitrators therefore concluded that the level of reasonable but not excessive remuneration for NHKTC remained an IRR between 15% and 17% over the life of the franchise, as was decided in the 1997 arbitration. In making the Award, the Arbitrators also anticipated that it might be necessary for a further similar increase in about 5 years.

NHKTC'S APPLICATION FOR TOLL INCREASE

9. NHKTC submitted on 23 August 2010 its third application for a \$10 or 40% toll increase for private cars and taxis with proportionate increases for other categories of vehicles to take effect from 1 October 2010 (which was subsequently revised to 1 January 2011). The existing and proposed toll levels by NHKTC are set out at **Annex B**.

NHKTC's Justification for Toll Increase

10. A note on the toll increase application, prepared by NHKTC, is at **Annex C**. In brief, NHKTC has advanced the following justifications –

- (a) according to the arbitration award made in 1997, a reasonable return was defined as an IRR between 15% and 17%. Over the past few years, the company has been operating at below the lower end of its expected IRR; and
- (b) should there be no toll increases, the IRR over the whole franchise period is estimated to be 14.26% which is less than the lower range of a reasonable return. Even with the current proposed toll increase, the IRR likely to be achieved over the life of the franchise is estimated to be 14.51% which still falls short of the lower range of a reasonable return.

NHKTC's Financial Performance

11. NHKTC has consistently achieved a healthy financial position. It started to make an operating profit in 1992, i.e. about three years after the commissioning of the EHC and also wiped off the accumulated loss by end 1993. According to NHKTC's actual financial results, by end of December 2009, NHKTC had accumulated a profit of about \$4,688 million. NHKTC has fully repaid its bank loans in July 2001 and started to pay dividends from 1994 onwards, and dividends have been paid on a monthly basis since October 2001. Total dividends paid up to the end of 2009 amounted to \$4,658 million.

12. As far as the application for toll increase is concerned, NHKTC forecasts that the toll revenue in 2011 would increase from about \$736 million by \$164 million (+22%) to about \$900 million. This has taken into account the assumed toll increase of about 40% on 1 January 2011, but after netting off the projected decrease in EHC traffic by about 13% arising from the proposed toll increase.

13. According to NHKTC's latest projections in the current toll increase application taking into account actual dividends, the estimated IRR over the 30-year franchise will increase from 14.26% without toll increase to 14.51% with toll increase assumed on 1 January 2011.

The Administration's Assessment

Guiding Principle – Reasonable but not Excessive Remuneration

14. In considering NHKTC's franchise bid in 1986, the Government agreed the opening tolls but gave no undertaking in respect of any subsequent toll increase. Neither was there any discussion nor agreement between Government and NHKTC on the level of the IRR. Each toll increase application will have to be considered on its own merits.

Traffic Assessment

15. From the traffic management point of view, the average daily traffic throughput of the EHC in 2009 and 2010 are 63,000 and 67,500 respectively against its design capacity of 78,500 vehicles per day. No undue congestion is observed at the tunnel's approach roads.

Public Affordability and Acceptability

16. The Administration has urged NHKTC to reconsider the need and the timing for any toll increase under the current economic situation. We have also reminded them of the importance of striking a balance between the interest of the community at large and commercial considerations in devising their tolling strategy, as well as to have due regard to public affordability and acceptability. Despite our persuasion, NHKTC maintained that the application be submitted to the Chief Executive-in-Council for consideration as soon as possible.

Arbitration

17. If the toll increase application is rejected, NHKTC may resort to arbitration. The arbitration rulings in 1997 and 2005 will be regarded as a reference of what constitutes a "reasonable but not excessive remuneration". It is however not binding on subsequent cases and each case has to be considered on its own merits. Under the EHC Ordinance, the arbitrator is required to have regard to, *inter alia*, any material change in the economic conditions of Hong Kong since the enactment of the Ordinance or, as the case may be, since tolls were last determined.

ADVICE SOUGHT

18. Members' views are invited on NHKTC's application for toll increases at the EHC.

Transport and Housing Bureau
February 2011

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Chapter:	215	Title:	EASTERN HARBOUR CROSSING ORDINANCE	Gazette Number:	
Section:	55	Heading:	Road Company to charge approved tolls for use of road tunnel	Version Date:	30/06/1997

(1) Subject to this Ordinance, the Road Company may demand and collect tolls in respect of the passage of motor vehicles through the road 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 Road 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 Road 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 Road Company of its obligations, or the exercise of its rights, under this Ordinance is reasonably but not excessively remunerative to the Road 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 Road Company made under section 75;
- (c) any material change in any other circumstances affecting the exercise by the Road Company of its rights under the franchise granted by section 4(1);
- (d) the effect of the introduction of, or alteration in, any tax or levy imposed on the use of the road tunnel;
- (e) the principle that tolls or future rights to tolls should not be used to finance the construction of the railway works or to discharge directly or indirectly any obligation imposed on the Rail Company by this Ordinance; and
- (f) any other relevant matter.

(5) Where under subsection (3)-

- (a) the Governor in Council and the Road Company agree to a variation of the tolls; or
- (b) in an award pursuant to 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.

(6) The Commissioner shall, by notice in the Gazette, as soon as is practicable after such agreement or award as is referred to in subsection (5) amend the Schedule.

(Enacted 1986)

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Eastern Harbour Crossing Toll Schedule

Vehicle Type	Current Toll Level (\$)	Proposed Toll Level (\$)	% increase
Motorcycle	13	18	38%
Private Car	25	35	40%
Taxi	25*	35	40%
Public and Private Light Bus	38	54	42%
Light Goods Vehicle	38	54	42%
Medium Goods Vehicle	50	70	40%
Heavy Goods Vehicle	75	105	40%
Public and Private Single-Decker Bus	50	70	40%
Public and Private Double-Decker Bus	75	105	40%
Each Additional Axle in excess of two	25	35	40%

* According to NHKTC, toll for empty taxi will remain at \$15 until 30 September 2011.

**NEW HONG KONG TUNNEL COMPANY LIMITED
TOLL INCREASE APPLICATION
EXECUTIVE SUMMARY**

Background

- 1) The Eastern Harbour Tunnel (EHT) is a Build-Operate-Transfer project constructed and operated by the New Hong Kong Tunnel Company (NHKTC) under a 30-year franchise that was granted by the Government and commenced in 1986.
- 2) EHT is a critical piece of Hong Kong's transportation infrastructure – as in 2010, around 68,000 vehicles per day used the crossing.
- 3) The Eastern Harbour Crossing Ordinance states that the NHKTC is entitled to receive a *reasonable but not excessive remuneration* in exchange for taking the risk of building and operating the EHT during the franchise period, including the HK\$2.2 billion in construction costs paid by the NHKTC.
- 4) When the franchise was granted to the NHKTC in 1986, the financial plan for the crossing included regular toll increases of \$5 for private cars/taxis, and proportionate increase for other categories of vehicles at 5-yearly intervals beginning from 1992/1993 till 2003. This financial plan took into account the Government's indication that it wanted a toll regime that started at a relatively low level and grew over time; and the Government's recognition that this is a commercial project and tolls must be sufficient to reward the shareholders' interest in the project.
- 5) Under Section 55(3) of the Eastern Harbour Crossing Ordinance, tolls may be varied by agreement between the Chief Executive-in-Council and the tunnel company; or 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 Chief Executive-in-Council or the Road Company.
- 6) Since the EHT opened for road traffic on 21 September 1989, there have been two increases in the EHT toll in 1998 and 2005 respectively. In both cases the NHKTC sought and won arbitration in its application process.

The 1997 arbitration

- 7) The first toll increase application was submitted in May 1995 after the NHKTC's internal calculations showed that a \$10 toll increase was necessary for achieving a "reasonable return" over the life of the franchise. The Executive Council did not agree, so an arbitrator was appointed in January 1996 to decide the case.
- 8) In March 1997, the arbitrator ruled that:
 - a. The appropriate measure of return was an internal rate of return (IRR) percentage on equity after tax over the franchise period
 - b. The lower level of reasonable return was 15% and the upper level was 17%
 - c. The NHKTC should demonstrate that it will fall below this level over the franchise period in order to be entitled to a toll increase

- d. The intention of the Government and the NHKTC was that the tolls be raised gradually over the life of the franchise so that earlier tunnel users would not subsidize later users
- 9) Based on these principles the arbitrator awarded a toll increase of HK\$5 for private cars, along with proportionate increases for other vehicles, and recommended future increases of HK\$5 at approximately 5-year intervals.

The 2005 arbitration

- 10) In 2002, after waiting five years, as recommended by the arbitrator, the NHKTC applied for a second toll increase of HK\$5 for private cars (with proportional increases for other categories). The NHKTC justified its application on calculations that showed the IRR would not meet the 15% lower limit for a reasonable rate of return without an extra toll increase. The Chief Executive-in-Council rejected the NHKTC's application, and both parties each appointed an arbitrator to make a ruling on the toll increase application.
- 11) The Government argued that based on adverse changes to Hong Kong's economy since 1997, the reasonable rate of return should be adjusted downward to 12%-14%, and that without a toll increase the NHKTC's return over the life of the franchise would fall within that band.
- 12) In January 2005 the two arbitrators concluded that the level of remuneration which is reasonable but not excessive should, once ascertained, be maintained subject to exceptional economic or other changes in Hong Kong. Since the overall economic difference between 1997 and 2005 was not sufficiently material, the level of reasonable but not excessive remuneration for the NHKTC remains, as was decided in the 1997 Award, an IRR on equity after tax over the life of franchise of between 15% and 17%.
- 13) The two arbitrators ruled it was appropriate and necessary to award a HK\$10 toll increase for private cars, with corresponding increases for other vehicles, in order to place the NHKTC's IRR on a path to the lower limit of the reasonable but not excessive level of remuneration (i.e. an IRR of 15%). The two arbitrators anticipated a further, similar, increase in 2010 would be required.

The application for a toll increase in 2010

- 14) Five years have passed since the last toll increase. As the arbitrators anticipated, financial and traffic projections indicate that a further toll increase is necessary to bring the likely return to the NHKTC to nearer the lower level of the band of reasonableness of 15%. The arithmetic could justify a much bigger increase but NHKTC thinks HK\$10 toll increase is a good balance.
- 15) The NHKTC therefore applied to the Government for a HK\$10 toll increase for private cars and proportionate increases for other categories of vehicles on 23 August 2010. A schedule showing the existing and proposed tolls is set out in the Appendix.
- 16) Based on the current economic climate and traffic predictions, the NHKTC believes that the current toll schedule will not meet the 15% lower limit for reasonable but not excessive remuneration as determined by the two arbitrations. According to an IRR calculation by NHKTC in January 2011, without a toll increase the NHKTC will attain an IRR of 14.26% over the franchise period.

- 17) Even with the proposed toll increase, the NHKTC's IRR over the life of the franchise is expected to remain below the 15% lower limit.
- 18) While the NHKTC has worked to cut operating expenses, it also remains committed to improving and upgrading the tunnel facilities at the EHT, and will continue providing a safe and high quality tunnel service to the driving public.
- 19) This is the third application for a toll increase of EHT since the franchise was granted to NHKTC 25 years ago. While the NHKTC has a responsibility to serve the public, it also has an obligation to safeguard its shareholders' interest by providing the shareholders with reasonable but not excessive remuneration anticipated when the franchise was awarded.

Conclusion

- 20) The third toll increase application follows the rulings of two independent arbitrators who, in 2005 and after thorough analysis, concluded "reasonable but not excessive remuneration" had a 15% lower limit. Their conclusion was the same as that of the arbitrator in 1997.
- 21) Rejecting this current application and proceeding to arbitration will cause delay, which arithmetically will lead to a larger increase in toll than that applied for, as occurred in the 2002 application.
- 22) Questioning once again the level of reasonable but not excessive remuneration as determined through two arbitration processes may undermine Hong Kong's business environment resulting in private enterprises becoming hesitant to undertake the material risks inherent in similar infrastructure projects in the future.

New Hong Kong Tunnel Company Limited
17 February 2011

Appendix

Vehicle Type	Current Toll	Proposed Toll
Motorcycles	\$13	\$18
Private Cars and Taxis	\$25	\$35
Light Buses	\$38	\$54
Light Goods Vehicles	\$38	\$54
Medium Goods Vehicles	\$50	\$70
Heavy Goods Vehicles	\$75	\$105
Single Decker Buses	\$50	\$70
Double Decker Buses	\$75	\$105
Each additional axle in excess of two	\$25	\$35