Research Office
Legislative Council Secretariat

Information Note

Buying back privatized assets in selected places

IN15/17-18

1. Introduction

1.1 In Hong Kong, retail and carparking facilities are provided in the public rental housing ("PRH") estates and Home Ownership Scheme ("HOS") estates in order to cater for the daily needs of residents of these estates.[1] In 2005, the Hong Kong Housing Authority ("HA") divested 180 retail and carparking facilities through The Link Real Estate Investment Trust (renamed as Link Real Estate Investment Trust ("Link") in 2015)[2] with a view to enabling HA to focus on its core function of providing subsidized public housing, improving HA's financial position in the short-to-medium term, as well as enhancing the operation efficiency of the commercial facilities concerned. These divested retail and carparking facilities now account for a majority of the commercial facilities operating in the PRH and HOS estates.

1.2 Since HA's divestment in 2005, many stakeholders have expressed concerns that Link's market-oriented commercial approach in managing the divested retail and carparking facilities would lead to high rental increases, thereby driving out small neighbourhood shops and depriving the grass-root residents of affordable living necessities and goods.[3] The disposal of 45 divested properties by Link in recent years has also induced worries about further increases in rentals of the commercial facilities and conversion of them for more profitable uses at the expense of the interests of the public housing residents. Some stakeholders have therefore urged the Government to buy back the units of Link or the divested properties owned by Link, expecting that

1 As stipulated in section 4(1) of the Housing Ordinance (Cap. 283), the Hong Kong Housing Authority is required "to secure the provision of housing and such amenities ancillary thereto as the Authority thinks fit" for the persons concerned.

2 Link was Hong Kong's first listed and largest real estate investment trust listed on The Stock Exchange of Hong Kong Limited. A real estate investment trust is a collective investment scheme constituted as a trust that invests primarily in real estate with the aim to provide returns to holders derived from the rental income of the real estate.

3 See Legislative Council Secretariat (2016 and 2018).

the operation mode of the divested properties would be changed and the interests of the public housing residents could be better served.[4]

1.3 Nonetheless, the Government has reiterated on several occasions that it does not have any plan to buy back Link or its commercial facilities. According to the Government, the main objective of HA in divesting its retail and carparking facilities is to enable HA to focus its resources on discharging its function of providing subsidized public housing. The proposal to buy back Link is not in line with the Government's policy objective.

1.4 The Government has indicated that buying back the units of Link is **not a viable option** to instil changes in Link's commercial principles of operation. As Link's operation is governed by the Code on Real Estate Investment Trusts of the Securities and Futures Commission ("the Code"),[5] the trust deed[6] and relevant legislation which contain provisions protecting the interests of unit-holders, the Government has stated that it cannot require Link to change its commercial principles of operation even if it buys back the units of Link and becomes a significant unit-holder.[7] The trustee independent of the management company of Link also has the obligation to ensure that all investment activities of Link are in the interests of the unit-holders and shall not allow any variation of the trust deed which will materially affect the interests of the unit-holders.[8]

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4 See Official Records of Proceedings of the Legislative Council (2008 and 2012) and Legislative Council Secretariat (2018).

5 The Code regulates all publicly offered real estate investment trusts in Hong Kong, containing provisions that govern their operations, investments, management and corporate governance. Failure to comply with the Code may cause the Securities and Futures Commission to consider whether such failure adversely reflects on the suitability of the real estate investment trusts to remain authorized.

6 The trust deed is a principal document governing the formation and operation of Link, laying down, among others, the structure of Link, rights and interests of unit-holders, and roles of the management company and trustee of Link. According to the trust deed, any proposal to terminate Link will require approval of unit-holders by special resolution, unless the proposed termination is arising from the consequence of legal challenge against its divestment and/or public offering.

7 A significant unit-holder refers to a unit-holder holding 10% or more of the units of Link. According to the Code, significant unit-holders are not allowed to vote in transactions where a conflict of interest arises.

8 See Official Records of Proceedings of the Legislative Council (2008 and 2012).

1.5 The **high cost** involved in buying back the units or properties of Link is another barrier for the Government to consider the proposal. The Government has maintained that the proposed buy-back exercise would involve a significant amount of public funds which could be spent on services for improving people's livelihood directly. The Government's buy-back intention or decision may drive up the prices of the units or properties of Link, thereby pushing up the acquisition costs and benefitting the existing unit-holders or property owners. In light of the above considerations, the Government has regarded buying back the units or properties of Link to be incompatible with public interests and the principle of prudent financial management.[9]

1.6 The Government has recently further stated that it will ensure Link's compliance with the relevant legal documents such as the land leases and assignment deeds which govern Link's and the new property owners' changes in use of the divested commercial facilities and disposal of the facilities by individual units under specific circumstances. The Government has also planned to build public markets in new development areas such as Tung Chung and Hung Shui Kiu with a view to meeting the grocery shopping needs of the local residents.[10]

1.7 Notwithstanding the above stance of the Government, there have been continued calls from some stakeholders to buy back Link or the divested commercial facilities amid concerns over the commercial approach in managing the divested facilities. At the request of the Subcommittee on Issues Relating to Shopping Centres, Markets and Carparks in Public Rental Housing Estates and Home Ownership Scheme Estates, the Research Office has prepared this information note providing an overview on the trend and developments regarding the activities of buying back privatized public assets in overseas places. Specifically, the experiences of Germany and Malaysia in buying back the privatized utilities are highlighted. Through the buy-back initiatives, both places aimed to address the failure of the private enterprises to deliver efficient and/or value for money services expected from privatization, and regain influence on the development of the service sectors concerned so that public interests can be better served.

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9 See Official Records of Proceedings of the Legislative Council (2008 and 2012) and Transport and Housing Bureau (2014).

10 See Official Records of Proceedings of the Legislative Council (2012 and 2018).

2. Global trend and developments

2.1 In the 1980s and 1990s, privatization of publicly-owned enterprises/public services at the national and local levels was a common phenomenon in different parts of the world, particularly in the sectors of electricity, telecommunications, water supply, railways, airlines and banks. Reasons underlying the privatization initiatives included raising revenues, reducing costs/debts of the government concerned and improving efficiency of the rest of the government functions. The profit-seeking principle of the private owners was also expected to bring efficiency and quality improvements in the service sectors concerned, thereby enhancing customer satisfaction.

2.2 Nonetheless, the tide of privatization of public services has reversed since the 2000s. Numerous cases of renationalization[11] or remunicipalization[12] of privatized public services/assets were seen in different countries or places. For cases that involved buy-back of privatized assets, many were related to buying back strategically important assets held by private enterprises facing **financial problems and possible closure of business**. Notable cases included renationalization of (a) Air New Zealand in 2001 and Tranz Rail in 2008 in New Zealand; (b) the railway infrastructure in the United Kingdom ("UK") in 2002; and (c) Aerolineas Argentinas in Argentina in 2008.

2.3 Another type of renationalization or remunicipalization were prompted by **failure of the privatized enterprises to deliver expected benefits of privatization** such as improvement in efficiency and quality of services and price reduction; and the **demand for changes** in the development direction of the sectors concerned to better serve the interests of the public. These factors had triggered the responsible government authorities to buy back the privatized public services/assets to regain control on the development direction of the service sectors concerned and to implement related policy initiatives more effectively. Prominent cases of this category included (a) remunicipalization of utility firms holding electricity distribution grids ("electricity grid") in some municipalities of Germany since the 2000s; and

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11 Renationalization refers to the bringing back of privatized assets and/or industries into government ownership.

12 Remunicipalization refers to the taking back of municipal functions, services and/or assets that were privatized previously by the municipal government. See Wagner, O. and Berlo, K. (2017).

(b) buying back the water supply facilities from private water operators in Malaysia since the mid-2000s.[13]

2.4 Renationalization of privatized public services is often a subject of political debate. For example, in 2017, the Labour Party in the UK raised the proposal about renationalizing the railway, water supply, energy and mail delivery services in its general election manifesto, claiming that renationalization would bring the service charges down. Opponents argued that renationalization, involving huge costs of acquisition, would adversely impact public finance with possible rise in debts and crowding out of other public spending. Yet, supporters counter argued that the assets bought back by the government would generate revenues which help cover the costs of debt. Yet opposition groups further raised that renationalization might make management decisions (e.g. infrastructure investment and service pricing) being politicized, affecting the performance of the renationalized enterprises or long-term efficiency of the sector concerned.[14]

2.5 While there are different views towards renationalization or remunicipalization, a buy-back decision tends to be underpinned by a host of prevailing and industry-specific factors. The following section focuses on studying the buy-back experiences in Germany and Malaysia mentioned in paragraph 2.3 which are relatively more relevant to the case of Hong Kong in terms of the underlying reasoning leading to the buy-back calls. The ensuing paragraphs will give a brief account on the background of the two cases, followed by a discussion on (a) the factors conducive to the buy-back initiatives; (b) implementation of the initiatives including the buy-back approach, financing arrangement and management of repurchased assets; and (c) post-acquisition developments.

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13 In many other cases, privatized public services were taken back by the municipal governments concerned through the cancellation of or after the expiry of service or concession contracts without involving buy-back of assets. These cases are not relevant to this study.

14 See Financial Times (2017 and 2018).

3. Buy-back experiences in selected places

Background of the buy-back initiative in Germany

3.1 In Germany, initiatives to privatize municipal utility firms[15] were seen as early as in the 1980s, and became more common in the 1990s following implementation of the European Union directives on liberalization of the energy markets.[16] At that time, there was pressure from the large electricity companies[17] to open up the market. Coupled with the government's weak fiscal position,[18] many municipalities privatized the municipal utility firms by selling all or part of the shareholding to large electricity companies which were expanding their presence in the distribution market.

3.2 However, since the mid-2000s, some municipal governments have remunicipalized the management of the electricity grids and retail supply of electricity by either **establishing new municipal utility firms or buying back the privatized utility firms which owned the electricity grids**, along with taking back of the concession contracts[19] for managing the electricity grids. Hamburg and Stuttgart were among the larger cities in Germany that had successfully implemented the buy-back initiatives (the case of Hamburg is discussed below). On the other hand, Berlin, the largest city of Germany, did not successfully proceed with remunicipalization due to its weak fiscal position and lack of public support for there were concerns that the government might not be capable of managing the assets after buying back.[20]

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15 Municipal utility firms in the electricity sector are responsible for managing the local electricity grids and supplying electricity to the local end-users. They are public service institutions and their operations are guided by public welfare obligations.

16 The European Union introduced the first liberalization directive for the electricity market in 1996 and the natural gas market in 1998 with a view to opening these markets to competition gradually.

17 Large electricity companies dominate the electricity generation and transmission markets in Germany and some of which also operate in the distribution and retail markets.

18 In the 1980s and 1990s, the municipal governments faced tough budgetary cuts following austerity policy adopted by the federal and state governments. See Wagner, O. and Berlo, K. (2017).

19 Under a concession contract, the municipal government grants an operator the right to build and operate an electricity grid, and make use of the related public roads and infrastructure for building the grid. The concession contract is granted under a competitive process and lasts for 20 years or less.

20 In Berlin, the referendum on the proposal to buy back the electricity grid held in November 2013 failed. Opponents of the proposal claimed that the existing operator of the electricity grid had been reliable and the local government might not have sufficient experience in managing the electricity grid and related construction works as reflected by the poor management of the new airport construction project. Besides, buying back the electricity grid would further increase the debt burden of Berlin. See Spiegel Online (2013) and BBC (2013).

Background of the buy-back initiative in Malaysia

3.3 In the 1990s, management of the water infrastructure and provision of water services in Malaysia were under the purview of the individual state governments, with interest-free loans provided by the federal government for capital investment and tariff subsidies. While some states set up their own companies to provide water services, some states, including the more developed and populated states of Selangor and Johor, had privatized water supply services through granting long-term concession contracts to private water operators. The move was prompted by the need to speed up infrastructure upgrades in order to meet the fast-growing economic development needs of the states. After over a decade of private operations, the federal government of Malaysia in 2006 introduced a reform in the water sector by buying back the water-related assets to improve the efficiency and quality of water services across states.[21]

Factors driving the buy-back initiatives

3.4 While the nature of the above buy-back cases was different, both were driven by the following factors:

(a) **issues with the private service providers** – there were operational or financial issues with the private service providers in the above cases. For example, in **Hamburg**, the parent company (Vattenfall) of the private utility firm (Stromnetz Hamburg GmbH) had been facing profitability problems following the federal government's plan to exit nuclear power, so selling the stake of the private utility firm helped ease the debt burden.[22] Similarly, the private water operators in **Malaysia** had faced growing debts since the water tariffs they charged on end-users were not enough to recover their full costs. Meanwhile, private water operators' lack of funds to upgrade the water infrastructure had resulted in concerns about their service quality and efficiency; and

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21 The asset acquisition process involved negotiations with private water operators for discontinuing the concessions and selling back their assets directly to the federal government or to the state governments concerned which then transferred back the asset ownership to the federal government. Transfer of asset ownership to the federal government also took place in states where water services were provided by state-owned water operators.

22 See Reuters (2013).

(b) **public dissatisfaction with the services and strong support of stakeholders including the government** – in **Hamburg**, there was public discontent over the private utility firm due to its slow response to the energy transition plan on increasing use of renewable energy. Members of the public supported remunicipalization through a referendum which was legally binding on the government. In Malaysia, the **Malaysian federal government had displayed strong political will** to reform the water sector to facilitate its sustainable development, and acquisitions of the water-related assets from the private water operators were the critical moves in the reform process, as prompted by the **stakeholders' dissatisfaction** over the performance of the private water operators.

Implementation of the buy-back initiatives

Buy-back approach

3.5 Acquiring shares or assets of a company are the two most common means of effecting an acquisition transaction. In **Hamburg**, the municipal government facilitated the buy-back by acquiring **100% of company stake**. At first, it acquired back 25.1% stake of the private utility firm in 2011 at a cost of €138 million (HK$1.5 billion). However, some stakeholders considered that the minority stake of 25.1% was not sufficient for the municipal government to take over the control of the assets.[23] As a result of the referendum,[24] the government proceeded in early 2014 to acquire the remaining 74.9% stake at a provisional cost of €412 million (HK$4.2 billion). The finalized agreed cost was adjusted down by 13.4% based on independent valuation. Upon approval of the government and completion of the necessary acquisition procedure, the private utility firm became publicly-owned utility firm. In **Malaysia**, the buy-back exercise was **asset-based** without involving share purchase of the private water operators, as the primary objective of the federal government was to take back all the water-related assets for development under its centralized control. The asset-free operators

[23] See World Future Council (2016).

[24] The referendum was held in September 2013, with 50.9% of voters in Hamburg voting in favour of the proposal.

remained privately owned and they continued their operation by leasing back the water assets from the government.

3.6 In both cases, the buy-back deals were made through **negotiations** between the responsible government authorities and the private operators or their parent company concerned. In the case of Hamburg, the final acquisition cost was determined based on valuation by an independent auditor jointly appointed by the parties involved in the deal. As for the case of Johor in Malaysia which has completed the buy-back process, the acquisition cost of the water-related assets of the private water operator was reportedly determined based on the audited book value of the assets.[25]

Execution of the buy-back plan

3.7 In both Hamburg and Malaysia, acquisition of the privatized assets concerned was executed through a **government-owned company**. In **Hamburg**, the acquisition of the private utility firm was made through one of the subsidiaries of the group holding company, HGV, owned by the municipal government. The group holding company also holds directly or indirectly most of other publicly-owned service companies such as water, electricity and transport companies in Hamburg. The setup of group holding company allows flexible financial management, enabling offsetting of profits and losses among its subsidiary companies and usage of the incomes for other investments.[26] In **Malaysia**, the federal government set up a dedicated public company, WAMCO, wholly-owned by the Minister of Finance Incorporated[27] for managing the acquisition and development of the water-related assets across the states. WAMCO is tasked with constructing and upgrading the water infrastructure and related assets, and obtaining competitive financing for the acquisition and development of the assets.

25 See New Straits Times (2009).

26 See HGV Hamburger Gesellschaft für Vermögens- und Beteiligungsmanagement mbH (2018).

27 Minister of Finance Incorporated is a corporation established under the Minister of Finance (Incorporation) Act 1957, empowered to enter into contracts, acquire, hold and maintain tangible and intangible assets. The Government Investment Companies Division under the Ministry of Finance is responsible for, among others, managing the investment activities of Minister of Finance Incorporated, and monitoring and ensuring good corporate governance practices in the related government-owned companies.

Financing arrangement

3.8 Forms of funding in a buy-back to a certain extent depend on the financial strength of the government and availability of low-cost funding in the market. In **Malaysia**, the government-owned company (WAMCO) was injected funding to facilitate acquisition of the water-related assets. The acquisition was also supported by a revolving credit of M$3 billion (HK$7 billion) secured from a leading local financial institution. For the development of the water-related assets, it was financed by funds raised from the financial institutions or capital markets (such as issuance of Islamic bonds), grants or soft loans from the federal government, and proceeds from lease rentals of the water-related assets. As a government-owned company, WAMCO was able to raise funds on the capital markets at more favourable rates than those obtained by the private water operators. It has also appointed a leading financial institution as the financial partner for implementing its long-term funding strategy.[28] As for the buy-back case in **Hamburg**, the acquisition of the private utility firm was funded by the government-owned group holding company (HGV) but information on the financing arrangement and whether loans had been incurred was not available.

Management and operation of the repurchased assets

3.9 The approach to the management and operation of the repurchased assets varied in Germany and Malaysia. In **Hamburg**, the acquired utility firm has maintained the management of the electricity grid assets and provision of related services to end-users after being granted a 20-year concession contract by the municipal government. As a public utility firm wholly owned by the municipal government, its operation is based on the overarching energy transition policy of the government to provide environmentally friendly power supply.

[28] See Pengurusan Aset Air Berhad (various years).

3.10 In contrast, **Malaysia** has mainly adopted a **"buy-back and lease-back"** model in managing the acquired water-related assets. As mentioned above, while the public company WAMCO has repurchased the assets, operation and provision of water services are outsourced by way of asset lease to private water operators.[29] Since WAMCO is able to take advantage of its government backing to raise low-cost funds in the capital markets for development of the water infrastructure, it in turn offers water operators better rates on asset lease[30] so as to enhance their financial sustainability under a full cost recovery model. Being asset light, the private water operators are expected to be able to focus on maintaining efficiency and effectiveness of their operations.

Post-acquisition developments

3.11 After buying back, changes are seen in terms of development direction and/or operation efficiency in both cases. In **Hamburg**, the utility firm has changed its energy strategy to support the energy transition policy after it was taken over by the municipal government, through expansion of renewable energy sources and investment in modern smart grid. While the long-term economic benefit of buying back the electricity grid assets has yet to be seen, the utility firm generated an after-tax income of about €11.4 million (HK$97.9 million) from the related asset operation for the municipal government in 2016.[31]

3.12 In **Malaysia**, initial evaluation of the impacts of the water sector reform on the asset buy-back exercise indicated that there had been noticeable improvements in efficiency indicators such as the reduction of non-revenue water (e.g. reduction of leakage in the water distribution system) and **greater cost recovery** in certain states (i.e. Johor, Melaka and Negeri Sembilan) that have eased the debt burden of the water operators, as well as **bringing improvements** in the water infrastructure through asset buy-back.[32] For the

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[29] The private water operators are licensed and regulated by the National Water Services Commission for providing water services to the public. In some states, the water services are provided by state-owned water operators. The assets repurchased by the federal government are leased back to state-owned water operators for operation and maintenance.

[30] The lease rates are determined based on the reimbursement capacities of individual states and charged at a fixed percentage of the value of the assets ranging from 3% to 6%. The rate is generally lower than the interest rate that the water operators can obtain on the capital markets. See Pigeon, M. (2012).

[31] See Stromnetz Hamburg (2017).

[32] See WaterPolicy.online (2017).

state of Selangor, however, the **buy-back exercise has been protracted** due to **disagreement on the pricing terms** between the parties and over some political issues.[33] As a result, the whole process has not yet been completed. Nevertheless, the Selangor state government has planned that upon completing the buy-back exercise, it would **consolidate the assets under a new public water operator** for operation instead of leasing them back to the private water operators as in some other states with a view to providing more efficient and value for money water services to the public.

4. Concluding remarks

4.1 In Hong Kong, since HA's property divestment in 2005, there have been repeated calls from some stakeholders urging the Government to buy back the units of Link or divested properties amid concerns over the commercial approach in managing the facilities. However, the Government has on various occasions indicated that it does not have any buy-back plan, for that huge costs involved in a buy-back is incompatible with public interest and buying back the units of Link to become a significant unit-holder will not help change the commercial principles of its operation.

4.2 Globally, there have been cases of buying back privatized assets since the 2000s following a wave of privatization in the 1980s and 1990s, particularly in the sectors of public utilities, airline and railway. The reasons for buying back were likely due to financial problems of the privatized firms; or failure of them to deliver the expected benefits of privatization and meet the demand for changes in the development direction of the sectors concerned.

4.3 In Germany and Malaysia, the successful buy-back cases were underpinned by the operational or financial issues of the private service providers and strong support of the stakeholders. In the case of Hamburg, the private utility firm was slow in shifting to renewable energy, leading to strong public support for a government buy-back. Despite the high costs involved in shares repurchase, the move had brought economic benefits in terms of the revenue generated from operating the related services. However, not all cities in Germany successfully proceeded with the buy-back

[33] The buy-back negotiations were politicized as the federal government and the state government have been led by the opposing political parties since 2008. See Water Remunicipalisation Tracker (2015).

plan, like the case of Berlin due to weak fiscal position and lack of public support for there were concerns over the government's capability in managing the assets.

4.4 In Malaysia, the government's buy-back move was partly arising from high tariffs, low efficiency and under investment of the private operators. Though massive costs were incurred in buying back the privatized assets, the federal government's access to low-cost funding has made the buy-back initiative viable. Moreover, its "buy-back and lease-back" operating model is expected to enable the private operators to focus on the core function of providing water services.

4.5 In both cases of Germany and Malaysia, buying back the assets involved negotiations with the private operators or their holding companies through a government-owned company. Nonetheless, the buy-back process from initiation to completion may take quite some time.[34] As in the case of Selangor in Malaysia, the process has not been smooth due to disagreement on pricing terms and political struggle among stakeholders having conflicting interests, which protracted the negotiation process, and the acquisition deal with all private water operators has not yet been completed.

[34] For example, in Hamburg, stakeholders had called for buying back the energy grids since 2010, and the buy-back process was only completed in end-2014. As for Malaysia, the federal government commenced the water sector reform in 2006 and the deal for buying back the water-related assets in Johor was concluded in 2009.

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