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Legislative Council

LC Paper No. CB(1)1095/03-04
(These minutes have been seen
by the Administration)

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Panel on Financial Affairs

Minutes of meeting
held on Monday, 5 January 2004 at 10:00 am
in the Chamber of the Legislative Council Building

Members present	**:**	Hon Ambrose LAU Hon-chuen, GBS, JP (Chairman) Hon Henry WU King-cheong, BBS, JP (Deputy Chairman) Hon James TIEN Pei-chun, GBS, JP Hon Albert HO Chun-yan Hon LEE Cheuk-yan Dr Hon Eric LI Ka-cheung, GBS, JP Dr Hon David LI Kwok-po, GBS, JP Hon NG Leung-sing, JP Hon James TO Kun-sun Hon Bernard CHAN, JP Hon CHAN Kam-lam, JP Hon SIN Chung-kai Hon Jasper TSANG Yok-sing, GBS, JP Hon Abraham SHEK Lai-him, JP
Non-Panel Member attending	**:**	Hon Audrey EU Yuet-mee, SC, JP
Members absent	**:**	Hon Kenneth TING Woo-shou, JP Dr Hon David CHU Yu-lin, JP Dr Hon Philip WONG Yu-hong, GBS Hon Emily LAU Wai-hing, JP

Public officers attending : Agenda Item IV

Mr Frederick MA, JP
Secretary for Financial Services and the Treasury

Mr Alan LAI, GBS, JP
Permanent Secretary for Financial Services and the Treasury (Treasury)

Mrs Lucia LI, JP
Director of Accounting Services

Mr K T LI, JP
Deputy Director of Accounting Services

Mr C H TSANG, JP
Assistant Director of Accounting Services

Agenda Item V

Mr Martin GLASS, JP
Deputy Secretary for Financial Services and the Treasury (Treasury)

Mr Tommy YUEN
Principal Assistant Secretary for Financial Services and the Treasury (Treasury)

Mr Richard FAWLS
Senior Assistant Law Officer (Civil Law)
Department of Justice

Agenda Item VI

Mr Martin GLASS, JP
Deputy Secretary for Financial Services and the Treasury (Treasury)

Mr K C TAM
Deputy Commissioner of Inland Revenue (Technical)

Miss S K LEE
Senior Government Counsel (Treaties and Law)
Department of Justice

Mrs Ada LEUNG
Senior Assessor
Inland Revenue Department

Agenda Item VII

Mr Alan LAI, GBS, JP
Permanent Secretary for Financial Services and the Treasury (Treasury)

Ms Elizabeth TSE, JP
Deputy Secretary for Financial Services and the Treasury (Treasury)1

Mr John Anthony MILLER, JP
Permanent Secretary for Financial Services and the Treasury (Financial Services)

Ms AU King-chi, JP
Deputy Secretary for Financial Services and the Treasury (Financial Services)1

Mr N M LUK, JP
Deputy Commissioner of Inland Revenue

Ms Shirley LEUNG
Departmental Secretary
Inland Revenue Department

Clerk in attendance : Miss Salumi CHAN
Chief Council Secretary (1)5

Staff in attendance : Ms Pauline NG
Assistant Secretary General 1

Ms Connie SZETO
Senior Council Secretary (1)4

Mr Joey LO
Council Secretary (1)1

Ms May LEUNG
Legislative Assistant

Agenda Item V

Ms Connie FUNG
Assistant Legal Adviser 3

Agenda Item VIII

Mr Watson CHAN
Head (Research & Library Services Division)

Mr Jackie WU
Research Officer 1

I. Confirmation of minutes of meeting
(LC Paper No. CB(1)672/03-04 — Minutes of meeting on 6 November 2003)

The minutes of the meeting held on 6 November 2003 were confirmed.

II. Information papers issued since last meeting

2. Members noted the following information papers issued since the last regular meeting held on 6 December 2003:

(a) Public Consultation Paper on Feasibility of Establishing Policyholders' Protection Funds in Hong Kong with a copy of the letter dated 16 December 2003 from the Commissioner of Insurance (LC Paper Nos. CB(1) 606/03-04(01) and (02));

(b) Hong Kong Monetary Authority's first Half-yearly Monetary and Financial Stability Report (December 2003) (LC Paper No. CB(1)651/03-04);

(c) Information paper on "Results of further studies on proposal to turn Rating and Valuation Department into a trading fund" (LC Paper No. CB(1)681/03-04(01));

(d) Information paper on "Clearing bank for renminbi business in Hong Kong" (LC Paper No. CB(1)682/03-04(01)); and

(e) Information papers on "Enhancement of consumer credit data protection" (LC Paper Nos. CB(1)691/03-04(01) and (02)).

III. Date of next meeting and items for discussion

(LC Paper No. CB(1)671/03-04(01) — List of outstanding items for discussion

LC Paper No. CB(1)671/03-04(02) — List of follow-up actions)

Policy briefing on 15 January 2004

3. The Chairman reminded members that a special meeting, to be held on Thursday, 15 January 2004 from 3:30 pm to 4:30 pm, had been arranged for the Secretary for Financial Services and the Treasury to brief the Panel on the relevant policy initiatives featuring in the Chief Executive's 2004 Policy Address.

Regular meeting on 2 February 2004

4. The Chairman reminded members that as agreed at the last Panel meeting held on 6 December 2003, the following three items had been placed on the agenda for the regular meeting to be held on Monday, 2 February 2004 from 10:00 am to 1:00 pm:

(a) Briefing on the work of the Hong Kong Monetary Authority;

(b) Governance of the Hong Kong Monetary Authority; and

(c) Functions and responsibilities between the Financial Secretary and the Monetary Authority in monetary and financial affairs.

(*Post-meeting note:* At the request of Dr Hon David LI and with the concurrence of the Chairman, an additional item was included in the agenda for the Panel meeting on 2 February 2004 — "Briefing on the draft Standard Chartered [Bank] (Hong Kong) Limited (Merger) Bill". The revised agenda was issued to members on 15 January 2004.)

IV. Accrual-based consolidated accounts of the Government

(LC Paper No. CB(1)671/03-04(03) — Paper provided by the Administration)

Briefing by the Administration

5. Upon invitation by the Chairman, the Secretary for Financial Services and the Treasury (SFST) briefed members on Government's plan to publish the first set of accrual-based accounts for 2002-03. SFST advised that in May 2001, the Administration had briefed members on its initiative to publish two separate sets of annual accounts, one under the existing cash accounting convention and the other on

the accrual basis as recommended by the Task Force on Review of Government Financial Reporting Policy (the Task Force). The recommendations of the Task Force had then been published for public consultation. In June 2002, the Administration had published the Task Force's report, informed members of the public comments which were generally supportive of the initiative and the proposed way forward on the Government's financial reporting policy. SFST also pointed out that the existing cash-based accounts served mainly to demonstrate compliance with the cash-based budgets whereas the accrual-based accounts focused on the financial performance and position of the Government and Government-owned entities as a whole. Hence, the accrual-based accounts would enhance transparency of the Government's financial position and performance, and promote greater awareness of public finances in the community.

6. At the Chairman's invitation, the Director of Accounting Services (DAS) gave a power point presentation on the Accrual-based Consolidated Accounts for the year ended 31 March 2003 (the Accrual Accounts for 2002-03) and the broad directions for refining these accounts for subsequent years. DAS highlighted the following points:

(a) In accordance with the recommendations of the Task Force, for the financial year 2002-03, the Administration would publish the first set of accrual-based consolidated financial statements to report on the overall financial performance and position of the Government. For the financial years 2002-03 and 2003-04, the fixed assets to be included in the accrual-based consolidated financial statements would only cover those owned by the Hong Kong Housing Authority (HKHA). For the financial year 2004-05 and thereafter, the accrual-based consolidated financial statements would include government-owned fixed assets and depreciation. A Stewardship Statement would be published to report on the major resources under the Government stewardship responsibility. A post-implementation review would be conducted in 2006-07 to take stock of the results achieved and assess the scope for further improvement.

(b) The existing cash-based accounts covered the General Revenue Account and the Funds established under section 29 of the Public Finance Ordinance (PFO) (Cap. 2), such as the Capital Works Reserve Fund and Loan Fund. The accrual-based accounts included the account of other funds established by the Government for specific purposes, such as Quality Education Fund; HKHA, government business enterprises, such as Trading Funds, and business enterprises in which the Government had an investment holding of not less than 20% and of which the Government shared the net earnings (e.g. Kowloon-Canton Railway Corporation (KCRC) and Mass Transit Railway Corporation Limited (MTRC)); and the Exchange Fund (EF).

(c) Additional information provided under the accrual-based accounts included financial assets, such as investments in Government business enterprises, loans (e.g. loans under the Home Starter Loan Scheme and civil servant housing loans); liabilities, such as provision for pensions for civil servants; accrual-based costs, such as annual provision for pensions for civil servants, and depreciation of government-owned fixed assets (starting with the accrual accounts for 2004-05). As such, accrual accounts would provide more comprehensive financial information of the Government covering its assets and liabilities, as well as assist in the formulation of public finance policies in the long run.

(d) The Accrual Accounts for 2002-03 included the following -

- Consolidated Statement of Financial Performance with operating expenses classified by nature and by function;
- Consolidated Statement of Financial Position;
- Consolidated Cash Flow Statement;
- Statement of Reconciliation Between the General Reserve Reported Under the Accrual Basis and the Consolidated Fund Balance (Fiscal Reserves) Reported Under the Cash Basis;
- Statement of Reconciliation Between the Surpluses/Deficits Reported Under the Accrual Basis and Under the Cash Basis; and
- Notes to the Financial Statements.

(e) As at 31 March 2003, the Government had a net deficit of $43.4 billion as shown in the Consolidated Statement of Financial Performance (table 11 of the presentation material) as compared to the deficit of $61.7 billion (table 17 of the presentation material) calculated under the cash basis.

(f) The net assets of the Government as shown in the Consolidated Statement of Financial Position as at 31 March 2003 amounted to $660.5 billion (tables 13 and 14 of the presentation material), comprising $112.6 billion fixed assets of HKHA (including both public housing and other non-residential facilities, such as car park), $330.4 billion net assets of EF, and $217.5 billion General Reserve.

(g) The General Reserve (table 16 of the presentation material) was the net financial asset, i.e. the difference between the total financial assets (including Government's investments placed with EF ($324.2 billion), investments in government business enterprises and other investments ($185.1 billion), and loans and other financial assets ($61.5 billion)) and liabilities (including pensions ($307.8 billion), untaken leave balance of civil servants ($20.3 billion), and other liabilities ($25.2 billion)). The General Reserve reported under the accrual basis was $217.5 billion while the Fiscal Reserves reported under the cash basis was $311.4 billion (table 18 of the presentation material).

(h) The Administration originally intended to publish in the Accrual Accounts for 2002-03 Departmental Service Cost Statements (DSCSs) on a limited basis to reflect the costs of the internal services of 11 central administrative departments. However, in the course of compiling the data, it was considered that publishing DSCSs with partial costing of the internal services would not present fairly the true costs of individual bureaux and departments. To avoid possible misinterpretation, the Administration would revisit the form and content of DSCSs to be published, particularly in relation to the costing of inter-departmental services.

(i) The Administration aimed to include government-owned fixed assets and depreciation in the financial statements starting with the accrual accounts for the financial year 2004-05, and to publish a Stewardship Statement describing in terms of physical measurements the major resources such as land, buildings and infrastructure assets employed by the Government in the delivery of public services. The resources in the Stewardship Statement would be reported in terms of physical measurements, such as areas and lengths for land and roads respectively, rather than in financial terms as the latter were costly to obtain and inherently arbitrary in nature. The Administration would also conduct a post-implementation review in 2006-07.

(*Post-meeting note:* The presentation material and the Accrual Accounts for 2002-03 were circulated to members vide LC Paper Nos. CB(1)713/03-03(01) and (02) on 6 January 2004.)

Discussion

General view

7. Members generally welcomed the publication of accrual-based accounts to provide more information on Government accounts with a view to enhancing public understanding of the financial position and performance of the Government. In this connection, Dr Eric LI commended the Government for publishing the accrual-based accounts. He also commented that the impact of Government financial activities, such as the issuance of bonds, disposal of Government assets and outsourcing, on public finance would be better reflected in accrual accounts.

Differences between accrual-based and cash-based accounts

8. Noting that the net deficit calculated under the accrual basis was smaller than that calculated under the cash basis (tables 11 and 17 of the presentation material) but the Fiscal Reserves reported under the cash basis was higher than the General Reserve

reported under the accrual basis (table 18 of the presentation material), Mr CHAN Kam-lam considered it necessary for the Government to explain the differences to the public so as to avoid misunderstanding of the financial position of the Government. In particular, Mr CHAN pointed out that despite the Accrual Accounts for 2002-03 indicated that the Government had sizable assets, the public should be made aware of the fact that a majority of the assets were fixed assets that could not be easily disposed of to meet Government's expenses.

9. DAS explained that the net deficit calculated under the accrual basis for 2002-03 was smaller than that calculated under the cash basis because the surpluses of EF and government business enterprises had been included as revenue in the accounts. As regards Government reserves, DAS explained that the difference between the General Reserve reported under the accrual basis and Fiscal Reserves reported under the cash basis was mainly caused by the fact that there were liabilities recognized under the accrual basis but not under the cash basis, such as provision for pensions.

10. As regards the inclusion of Government's fixed assets in the accrual accounts, the Permanent Secretary for Financial Services and the Treasury (Treasury) (PS/FST(T)) pointed out that while the fixed assets in the Accrual Accounts for 2002-03 only included those of HKHA, the Government would include its own fixed assets in the accrual accounts from the financial year 2004-05 onwards after the completion of the relevant identification and valuation exercise. PS/FST(T) assured members that the Administration would proceed with the exercise in a prudent manner.

11. Dr Eric LI pointed out that international standards on accrual accounting for the public sector were still under development. He urged the Administration to make improvements to the accounts and conduct the post-implementation review in 2006-07 in the light of emerging international standards. SFST appreciated Dr LI's views and agreed that there was room for improvement in the Accrual Accounts for 2002-03. The Administration was committed to providing more financial and non-financial information in the accounts for subsequent years and conducting a post-implementation review in 2006-07.

Accrual budgeting

12. Mr SIN Chung-kai enquired whether the Government had plans to prepare the Budget on an accrual basis. In reply, SFST advised that the Administration had no plan to adopt accrual budgeting. It would continue to prepare the Budget on a cash basis in order to comply with the statutory requirements stipulated under the PFO. PS/FST(T) supplemented that in order to reflect the financial performance of the Government, the accrual accounts would be published along with the Government Annual Accounts annually. As regards government budgeting practices of other jurisdictions, PS/FST(T) advised that an increasing number of developed countries had published their accrual accounts but only Canada, Australia and New Zealand had

adopted the accrual basis in preparing their budgets. At the request of Mr SIN, PS/FST(T) undertook to provide an information paper on the practices of these three jurisdictions.

(*Post-meeting note:* The information paper provided by the Administration was circulated to members vide LC Paper No. CB(1)1006/03-04(01) on 17 February 2004.)

Liabilities: Provision for pensions

13. Members expressed grave concern over the Government's huge liabilities of $307.8 billion for the provision of pensions as shown in the Accrual Accounts for 2002-03, which had become a financial burden of the Government.

14. In response, SFST said that the provision of pensions was the Government's long-term liabilities not expected to be paid-off over a short period of time. DAS further explained that for the purpose of accrual-based accounting, the Government's financial liabilities under the four major pension schemes as at 31 March 2002 and 31 March 2003 were assessed by an independent qualified actuary using the Projected Unit Credit Method. The principal actuarial assumptions used in arriving at the pension liabilities were provided in Note 22 of the Accrual Accounts for 2002-03. According to actuarial assessment, the Government was expected to pay off the liabilities over a long period of time of over 30 to 40 years. DAS added that as the new Civil Service Provident Fund Scheme had replaced the New Pension Scheme as the retirement benefits system for the civil servants appointed under the new civil service entry terms on or after 1 June 2000 and when they progressed onto permanent terms of appointment, it was not expected that Government's pension liabilities would continue to rise in the long run.

15. Given the implementation of the new Civil Service Provident Fund Scheme, Mr James TIEN considered that the Government's pension liabilities would reduce in due course. He asked whether the Administration had made any assessment of when the pension liabilities would start to fall. PS/FST(T) responded that the Administration had not made such an assessment. However, he undertook to look into the feasibility of making the assessment in future.

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16. Responding to Mr James TIEN's further enquiry, SFST advised that the Government's pension liabilities were basically unfunded. The pension legislation provided that payments of all pension benefits should be charged to the General Revenue. At present, the annual payment for pension benefits was about $12 billion. PS/FST(T) supplemented that to address civil servants' concern over the most unlikely event that the Government could not meet pension liabilities from the General Revenue, the Government had since 1995 maintained a Civil Service Pension Reserve Fund which could cover the pension payment for one year. The balance of the Fund was $12.37 billion as at 31 March 2003.

17. In reply to Mr NG Leung-sing's enquiry on details of "Other liabilities" shown in the Consolidated Statement of Financial Position (table 16 of the presentation material), DAS said that major items included gratuities for contract staff, deposits from tax reserves certificates and water charges, as well as account payable items.

Liabilities: Untaken leave of civil servants

18. Mr Abraham SHEK was surprised to note that the Government had made a provision of $20.3 billion for untaken leave accumulated by civil servants. He considered that the problem reflected the poor management of the Government, and queried why civil servants were allowed to accumulate their annual leave until retirement when the untaken leave would be calculated at the final salary level of the retirees. Mr James TIEN raised the same query and pointed out that untaken leave should be calculated at the current salary level of a civil servant when the leave was earned instead of calculated at the final salary level when he left the Government. Mr NG Leung-sing suggested that the Administration should consider requiring civil servants to exhaust their untaken leave before leaving the Government in lieu of providing payments for untaken leave.

19. SFST explained that the provision for untaken leave indicated the overall amount of leave earned but not yet taken by the serving 170 000 civil servants calculated at their current salary levels as at 31 March 2003. It was expected that as and when civil servants cleared their untaken leave balance, such liability for the Government would decrease. In case civil servants had untaken leave when leaving the Government, the liability for untaken leave would be absorbed within the salary provisions for the departments concerned. PS/FST(T) added that as both leave earning rates and leave accumulation limits had been substantially reduced for civil servants recruited after May 2000, the liability for untaken leave would decline over time. He undertook to reflect members' concern to the Civil Service Bureau for consideration.

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Assets: Fixed assets of HKHA

20. Mr NG Leung-sing pointed out that management and maintenance of HKHA's fixed assets of $112.6 billion would have cost implication on the Government. He enquired how such cost was reflected in the Accrual Accounts for 2002-03. In response, DAS said that the housing and non-housing facilities of HKHA were recognized as fixed assets of the Government and shown in the Consolidated Statement of Financial Position. Management and maintenance expenses were recorded under "Operating expenses - Housing" in the Consolidated Statement of Financial Performance (table 12 of the presentation material).

Assets: Other fixed assets owned by the Government or it enterprises

21. Mr NG Leung-sing enquired how the Administration would conduct valuation on its fixed assets. DAS advised that in respect of the fixed assets of HKHA reported in the Accrual Accounts for 2002-03, they were stated at cost less accumulated depreciation except for land which had not been included. The Administration planned to include government-owned fixed assets, including Government's buildings, plants and equipment, and their depreciation in the accrual accounts for 2004-05 onwards. For Government's buildings, valuation would only be conducted if their costs were not available.

22. Mr NG Leung-sing and Dr Eric LI were concerned that the value of Government's fixed assets could not be truly reflected if the land cost involved was not reported in the accrual accounts. Given that land was a valuable asset of the Government and that statutory bodies like HKHA, MTRC and KCRC had been granted with free land for development of public housing and transport infrastructure, Dr LI opined that information on land cost for these fixed assets should be included in the accrual accounts. In response, DAS advised that the international practice in government accounting was to report fixed assets at cost. This was a conservative measure to avoid conducting valuation exercises frequently. Nevertheless, the Administration would take into account members' views in conducting the post-implementation review in 2006-07.

23. Dr Eric LI re-iterated his view that information on land cost for the land granted to HKHA should be reported in the Accrual Accounts. The Chairman requested the Administration to provide the relevant information after the meeting.

> (*Post-meeting note:* The information on value of land held by HKHA as at 31 March 2003 was circulated to members vide LC Paper No. CB(1)1006/03-04(02) on 17 February 2004.)

24. Mr Henry WU enquired how the Hong Kong Monetary Authority's (HKMA) new accommodation purchased in 2001 was reported in the Accrual Accounts for 2002-03. DAS advised that the accounts of EF (from where the operations of HKMA were funded) were consolidated in the Accrual Accounts on an equity basis. Valuation of assets for the accounts of EF was conducted by HKMA.

25. As regards fixed assets held by government business enterprises, DAS advised that valuation was done by the enterprises and the results were reported in the audited accounts published by the respective entities. The accounts of government business enterprises were consolidated in the Accrual Accounts for 2002-03 on an equity basis. The fixed assets reported in the Accrual Accounts for 2002-03 were those of HKHA, whose accounts were consolidated on a line-by-line basis. On the financial reporting

practices of government business enterprises, DAS advised that these enterprises, including Airport Authority, KCRC and MTRC, had adopted the accrual basis.

26. Mr James TO enquired about the feasibility of standardizing the accounting policies adopted by various entities consolidated in the accrual accounts to facilitate public understanding. PS/FST(T) pointed out that as different entities had established their own accounting policies to meet their needs and had published their own audited accounts, it might not be appropriate to require the entities to adopt standardized accounting policies.

Provision of DSCSs

27. On the provision of DSCSs, Dr Eric LI was of the view that the Administration should provide a clear timetable for publishing the information. In reply, SFST re-iterated that it was the Administration's original intention to publish DSCSs for 2002-03 with the costs of services provided by 11 central administrative departments such as Audit Commission, Treasury and Information Services Department which had already been doing annual costing for their services provided to other departments and bureaux. However, due to the concern that publication of partial costing of internal services would not present fairly the true costs of individual bureaux and departments, the Administration had not provided any DSCSs in the Accrual Accounts for 2002-03. Given the complex issues involved, the Administration needed time to resolve the issues. SFST expected that the issues would be resolved within two years.

28. Mr James TIEN enquired how office accommodation cost incurred by bureaux and departments accommodated in Government buildings was reflected in the accrual accounts. In response, DAS said that information on cost for office accommodation would be provided in the DSCSs. In this connection, Mr TIEN opined that Government offices should be accommodated in Government buildings in order to save operating cost as far as possible. In reply, PS/FST(T) said that it was the Administration's established policy that Government offices be accommodated in Government buildings as far as possible. In anticipation of further reduction in the civil service establishment in the next few years, the Administration would, where appropriate, relocate offices from rented accommodation to Government premises with a view to achieving savings in rental cost.

V. Resolution to authorize the Government to borrow by way of securitizing Government revenue receivable from tolls on bridges and tunnels

(File Ref: FIN CR1/4651/01 — Legislative Council (LegCo) Brief on "Resolution to Authorize the Securitization of Future Revenue from Government Toll Roads" issued by Financial Services and the Treasury Bureau

LC Paper No. CB(1)693/03-04(01) — Loans Ordinance (Cap. 61))

Briefing by the Administration

29. At the invitation of the Chairman, the Deputy Secretary for Financial Services and the Treasury (Treasury) (DS/FST(T)) briefed Members on the Administration's proposal to securitize Government revenue receivable from tolls on bridges and tunnels by offering notes or other financial instruments backed by such revenue to investors. DS/FST(T) highlighted the following points:

(a) The Government had announced in the 2003-04 Budget its intention to dispose of or securitize $112 billion of assets in the next five financial years and set a target to raise an estimate of $21 billion in 2003-04. Subject to market conditions and the final structure and tenor to be agreed with the arrangers, the Administration expected that the proposed securitization would bring in one-off capital revenue of up to $6 billion. Coupled with the about $16 billion proceeds raised from the sale of government loans to Hong Kong Mortgage Corporation completed earlier, the Administration's target of raising about $21 billion of capital revenue would be met.

(b) The revenue generated from disposing of or securitizing Government assets would help partially off-set the expected $31 billion expenditure in capital works projects in 2003-04. Moreover, the securitization exercise would help promote Hong Kong's capital markets, provide market participants with an investment alternative, and maintain Hong Kong's position as an international financial centre.

(c) The securitization would be implemented by issuing notes or other financial instruments (the Notes) backed exclusively by future revenue, over a limited period, from Aberdeen Tunnel, Cross-Harbour Tunnel, Lantau Link (comprising Tsing Ma Bridge, Ma Wan Viaduct and Kap Shui Mun Bridge), Lion Rock Tunnel, Shing Mun Tunnels, and Tseung Kwan O Tunnel. In brief, the Government would issue the Notes to investors through a wholly-owned special purpose issuer (the Issuer).

The indicative average maturity for different tranches of the Notes would be eight to nine years. The Notes would entitle the investors to be paid annual or other periodic sums serviced from net revenue derived from the operation of the above toll bridges and tunnels. The proposed securitization structure and indicative terms were illustrated in Annex B to the LegCo Brief. These were subject to refinement after the Administration had engaged the arrangers for the execution of the transaction and after the discussion with regulatory authorities and credit rating agencies during the next few months.

(d) As the Government would not guarantee the return to investors and the traffic volume of the toll bridges and tunnels, arrangers and ultimately investors of the Notes might require the Government to disclose relevant information and provide certain undertakings. Key areas in respect of which the Administration might consider giving commitments to investors were set out in paragraph 7(a) to (f) and Annex C to the LegCo Brief. These included transport policy, toll adjustment risk, possible payment items by the Government, and insurance arrangements. These issues would be finalized after the details of the offer structure had been confirmed and discussion with regulatory authorities and credit rating agencies had been completed.

(e) The Administration aimed to resolve all issues, finalize the structure, and execute the necessary legal documents by mid-March 2004 to facilitate the offering of the Notes to investors, subject to prevailing market conditions.

30. DS/FST(T) added that in order to implement the securitization proposal, the Government planned to move a resolution under section 3(1) of the Loans Ordinance (Cap. 61) at the Council meeting to be held on 14 January 2004. The proposed resolution was set out in Annex A to the LegCo Brief.

Discussion

31. The Chairman drew members' attention to the following correspondence tabled at the meeting:

(a) First letter dated 30 December 2003 from the Assistant Legal Adviser (ALA) to the Administration;

(b) Reply dated 2 January 2004 from the Administration; and

(c) Second letter dated 2 January 2004 from ALA to the Administration.

(*Post-meeting note:* The three letters mentioned above were issued to members and non-Panel Members vide LC Paper No. CB(1)713/03-04(05) on 6 January 2004.)

32. Whilst expressing support for the securitization proposal in principle to raise funds for financing capital works projects as a measure to address the budget deficit problem, some members were concerned that the Administration had not provided adequate information for Members to consider the proposal.

Structure and target investors of the securitization exercise

33. Mr Henry WU enquired about details of the securitization exercise including the structure and target investors. DS/FST(T) said that these issues would be worked out with the arrangers. He added that the Administration had short-listed a number of investment banks for selection as the arrangers to execute the transaction. The Administration's aim was to complete the selection exercise by end of January 2004. As regards target investors, DS/FST(T) said that at the moment, the Administration's thinking was to issue both retail and institutional tranches. He however stressed that the Administration had not decided on the issue and would consider it after examining the proposals made by the arrangers. As there had been keen interest from retail investors on bonds offered by public bodies like the Hong Kong Mortgage Corporation, MTR Corporation Limited, and Airport Authority, the Administration envisaged that retail offer would form a major part of the exercise. It would also provide an alternative investment avenue for the general public.

Inclusion of Lantau Link in the securitization exercise

34. Given that Lantau Link generated low toll revenue at present, Mr CHAN Kam-lam expressed concern on whether it was appropriate to include it in the securitization exercise. Whilst appreciating that Lantau Link had very good prospects in earning toll income in future in the light of the anticipated increase in traffic volume resulting from the development of the Hong Kong-Zhuhai-Macau Bridge and the Tung Chung New Town, Mr CHAN doubted whether it was the best time to securitize the revenue from Lantau Link at present.

35. DS/FST(T) advised that the Administration was still considering whether Lantau Link should be included in the securitization exercise. Referring to paragraph 17(c) and the relevant footnote of the LegCo Brief, he pointed out that the Administration was considering the economics of its inclusion. DS/FST(T) agreed that it would be marginal in economic terms to include Lantau Link in the securitization exercise because it was still at the early stage of its economic life and was not generating much revenue. However, with the anticipated increase in traffic volume resulting from the further development of the Lantau Island, the increase in air traffic at Hong Kong International Airport, the opening of the Disney Theme Park and the construction of the Hong Kong-Zhuhai-Macau Bridge, the financial performance of Lantau Link would be improved. It was believed that the inclusion would enhance the attractiveness and appeal of the Notes to investors, in particular overseas investors, given that the facility was an internationally recognized landmark of Hong Kong.

Admin DS/FST(T) took note of Mr CHAN Kam-lam's concern and assured Members that the Administration would consider the issue carefully with a view to arriving at a decision as soon as possible.

Interest rates of the Notes

36. Mr James TIEN pointed out that investors were mainly concerned about the level of return they could get from the Notes. Whilst considering the proposed average maturity of about eight to nine years for the Notes acceptable, Mr TIEN noted that the interest rates of the Notes were not defined in the Administration's proposal. DS/FST(T) said that the actual interest rates would very much depend on the detailed terms of the final package and the market conditions at the time of the issuance of the Notes. Such details would be set out in the securitization documents, offering documents and information materials available to investors when the Notes were offered. The credit rating on the Notes given by credit rating agencies would also influence the interest rate. If a better rating was achieved with the Government assuming an appropriate level of risks, the Notes would be attractive to investors even with a low interest rate offered. He assured Members that the Administration would endeavour to achieve the best deal in terms of raising the target proceeds from the securitization while protecting the interests of investors.

Possible payment items by Government

37. Mr CHAN Kam-lam noted that the Government was prepared to consider providing direct payments to the Issuer, and therefore the investors, in respect of business interruption events (e.g. non-operation of toll roads) due to force majeure (Item 3(i)(a) of Annex C to the LegCo Brief). He doubted whether it was necessary for the Government to do so because events like terrorist attacks were beyond the Government's control. As far as he knew, this practice was not common in respect of the notes issued by other authorities.

38. DS/FST(T) explained that at present, should there be disasters or terrorist events rendering the toll bridges and tunnels inoperable for a sustained period of time, the risk would be borne by the Government. Under the securitization exercise, the Government would retain the ownership of the toll bridges and tunnels, but would not guarantee either the return to investors or the traffic volume of the facilities. It was reasonable for investors to require certain compensation payments from Government in the event that the facilities were unable to operate normally and generate the expected revenue over a sustained period of time due to events which were directly under Government's control or otherwise. It was therefore necessary to include "business interruption events due to force majeure" as a possible payment item. DS/FST(T) also confirmed that that was a normal feature of securitization exercises of
Admin the same nature. Mr CHAN Kam-lam was not convinced and requested the Administration to reconsider the issue.

39. Mr Henry WU noted from paragraph 7 of the LegCo Brief that the Government would not guarantee either the return to investors or the traffic volume of the toll bridges and tunnels, "but there will be certain recourse obligations of Government". He sought clarification on the recourse obligations involved. Senior Assistant Law Officer (Civil Law) clarified that there was no absolute right of recourse. The recourse obligations of the Government referred to events/matters that were within its direct or indirect control. For instance, in the event that a change in transport policy resulted in reduction in toll revenue, investors of the Notes might receive payments from the Government as compensation.

40. Referring to item 3(iii) of Annex C to the LegCo Brief where it was stated that the Government would exercise an option to exclude Cross-Harbour Tunnel from the securitization structure after the first five years of issuance of the Notes through early redemption, Mr CHAN Kam-lam was concerned that this provision might undermine the attractiveness of the Notes to investors. He considered it more appropriate for the Government to decide whether Cross-Harbour Tunnel should be excluded from the securitization structure before issuance of the Notes. In response, the Principal Assistant Secretary for Financial Services and the Treasury (Treasury) (PAS/FST(T)) explained that the provision would provide the Government with the flexibility should it consider exclusion of Cross-Harbour Tunnel from the structure desirable after issuance of the Notes. It enabled the Government to exercise an option to exclude Cross-Harbour Tunnel altogether from the structure through early redemption of the Notes or making direct payments to the Issuer calculated according to an agreed formula based on traffic volume, in exchange for a release of its obligation to pay to the investors actual revenues derived from Cross-Harbour Tunnel.

Government's undertakings to Issuer

41. Referring to item 5(ii) of Annex C to the LegCo Brief where it was stated that the Government would undertake that "it will not grant any other right or interest in the toll roads or assign or part with the interest in the agreements with operators", Mr CHAN Kam-lam enquired about the scope of the term "toll roads" and the purpose of this undertaking. PAS/FST(T) advised that the term "toll roads" referred to the bridges and tunnels covered by the securitization exercise and would not cover other toll bridges and tunnels in Hong Kong. The purpose of this undertaking was to assure investors that the Government would retain ownership of the facilities.

Toll adjustment risk

42. Mr NG Leung-sing noted from paragraph 7(b) of the LegCo Brief that while the Government would not guarantee a return to investors or a minimum level of traffic volume, it would discuss with the arrangers and credit rating agencies the extent of risk they would accept in relation to future toll adjustments, and that if an adjustment in toll levels by the Government resulted in a reduction in toll revenues, it might be necessary for the Government to make some compensatory payment to

investors. Mr NG doubted whether it was appropriate for the Government to compensate investors for a reduction in toll revenues arising from adjustment in toll rates in future and whether it was appropriate to use public moneys to compensate investors. He was concerned that should the Government undertake to assume risks relating to toll adjustments, it would be restrained in the adjustment of toll rates.

43. DS/FST(T) re-iterated that it would be fair for the Government to provide assurance to investors on matters within its control which would have adverse impact on the toll revenue. The more assurances the Government would provide to investors of the Notes, the lower the interest rate it needed to offer to investors, thus reducing the costs of issuing the Notes. He assured Members that the Administration would strike a proper balance between the need to protect the interests of investors and those of the general public. It would discuss the extent of the risk to be accepted in relation to future toll adjustment with the arrangers and the credit rating agencies so that the details would be available to investors as soon as possible.

Impact on transport policy

44. Mr Abraham SHEK indicated his support for the proposed securitization exercise. However, in view of the possible need for the Government to provide undertakings to investors in transport policy insofar as it might affect the traffic flow of the toll bridges and tunnels, in particular on cross-harbour traffic (paragraph 7(a) of the LegCo Brief), Mr SHEK was concerned that the Government's power in formulating transport policy (e.g. the optimization of the utilization of the Cross-Harbour Tunnel, Eastern Harbour Crossing and Western Harbour Crossing) might be constrained. In this connection, he commented that the Private Finance Initiative (PFI) model involving the building and operation of public infrastructure by the private sector might be a better option than the current proposal for the development of infrastructure.

45. In reply, DS/FST(T) re-iterated that ownership of the toll bridges and tunnels, including control over the arrangements with operators, the right to set toll rates and all other policy matters, would be retained by the Government. He also pointed out that the Financial Services and the Treasury Bureau had been working closely with the Environment, Transport and Works Bureau on developing a mechanism which would provide sufficient flexibility to the Government in formulating and implementing future transport policy and provide reasonable protection to investors. DS/FST(T) assured Members that the securitization exercise would not affect formulation of transport policy in future and that the Secretary for Environment, Transport and Works would retain the same power in formulating transport policy as at present. In future, should Government consider it necessary in the public interest to implement a transport policy on cross-harbour traffic, which would adversely affect toll revenue of Cross-Harbour Tunnel, the Government could exclude Cross-Harbour Tunnel from the structure of the Notes through early redemption.

46. DS/FST(T) further pointed out that the Administration was committed in involving the private sector in the provision of public infrastructure as far as possible. While the toll bridges and tunnels included in the securitization proposal were owned by the Government, they were managed and maintained by private operators with operation contracts awarded under competitive bidding. The Government would not rule out the PFI model for the development of public infrastructure, but as it involved the sale of Government assets and required legislative amendments which would take a long period of time to complete, the present securitization proposal was considered the best option to achieve the purpose of raising funds for the public works programme in 2003-04.

47. Responding to Mr Abraham SHEK, DS/FST(T) advised that should there be a substantial increase in net toll revenue, investors of the Notes would receive the same fixed amount of interest return and principal repayment, but potentially over a shorter period of time. The Government would receive the extra revenue at the end of the securitization period, and the Notes would be repaid over a shorter period.

Usage of the proceeds raised from the securitization exercise

48. Whilst expressing support for the securitization proposal to raise funds to finance capital works projects, Mr NG Leung-sing considered that the Administration should undertake that the proceeds raised from the securitization exercise would not be used to meet Government's recurrent expenditure. In response, DS/FST(T) advised that the aim of the proposed resolution was to authorize the Government to borrow for the purposes of the Capital Works Reserve Fund. The Secretary for Financial Services and the Treasury would confirm this point in his speech when moving the proposed resolution at the Council meeting.

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49. With the anticipated proceeds raised through disposal of and securitizing government assets, Mr Abraham SHEK commented that the Administration should consider investing more in public infrastructure. In respect of the $31 billion committed for capital works projects in 2003-04, DS/FST(T) said that the amount was what the Government had expected that it would be able to spend during the year. It might not be possible for the Government and its contractors to increase the expenditure within a short time having regard to the current state of projects in the public works programme.

Revenue generated by the bridges and tunnels concerned

50. Referring to paragraph 18 of the LegCo Brief, Mr Henry WU requested the Administration to provide a breakdown of the $1.5 billion gross revenue generated by the bridges and tunnels concerned in 2002-03. DS/FST(T) undertook to provide the relevant information after meeting.

(*Post-meeting note:* The breakdown of the $1.5 billion gross revenue and other relevant data provided by the Administration on the bridges and tunnels concerned were circulated to members and non-Panel Members vide LC Paper No. CB(1)717/03-04(01) on 6 January 2004.)

Securitized bonds Vs Government bonds

51. Responding to Mr James TIEN, DS/FST(T) advised that depending on the terms of the actual deal, different credit ratings would be achieved in respect of securitized bonds and Government bonds. If a good credit rating was achieved in respect of the Notes or securitized bonds, it was conceivable that the interest rate costs involved might be lower than those involved in the issuance of Government bonds. DS/FST(T) also pointed out that the Financial Secretary was considering whether the Government should issue straight bonds, a means which was commonly used by overseas Governments and public bodies to raise funds for infrastructure investment. If it was decided that the Government should do so, it would be a separate exercise from the present securitization proposal.

Experiences in other jurisdictions

52. Mr Henry WU enquired whether similar securitization exercises in other jurisdictions had been successful. DS/FST(T) advised that there were a number of examples of securitization of Government assets in general, and toll road revenues in particular. The Governments in several developed countries including the United States, Australia, France, and some other European countries had successfully completed securitization exercises of similar nature. It had been observed that toll revenue securitization was a common and effective method for Governments and public bodies to tap resources from the financial markets to fund infrastructure development and thus help improve their fiscal positions.

Way forward

53. In the absence of the details of the securitization exercise, Mr SIN Chung-kai and Mr Henry WU pointed out that it was difficult for Members to decide whether to support the resolution. Mr WU opined that the Administration should provide further information, including details of the "special purpose issuer" of the Notes and estimated costs of the securitization exercise. Given that the Administration's target was to issue the Notes by mid-March 2004, Mr SIN was concerned that if the House Committee decided at its meeting on 9 January 2004 to form a subcommittee to study the proposed resolution, there might be delay in implementing the proposal. Mr SIN urged the Administration to respond to Members' concerns and asked when the Administration could provide further information on the proposal to LegCo.

54. On the concern about insufficient information on the securitization exercise, DS/FST(T) said that the information in the LegCo Brief was the result of the work of Administration's financial adviser in the past two months. As details of the exercise, such as the actual transaction size and the pricing of the Notes, would be dependent on the prevailing market conditions and were beyond Government's control, the Administration could not provide further information on these aspects at the moment.

Nonetheless, the Administration would provide further information to address Members' concerns raised at the meeting as far as possible. The Administration would proceed with the appointment of the arrangers after the passage of the resolution to work out the prospectus and related documents of the Notes. It was expected that further details would be available in early March 2004 and the Administration would update the Panel on the progress of the exercise through an information note after the details had been worked out. DS/FST(T) assured Members that the Administration would endeavour to balance the interests of the general public and those of the investors in the process.

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(*Post-meeting note:* Further information provided by the Administration to address Members' concerns was issued vide LC Paper No. CB(1)735/03-04(01) on 8 January 2004.)

55. As regards the content of the proposed resolution, DS/FST(T) advised that while the proposal to raise funds through securitiating toll revenue was the first of its kind, similar resolutions had been passed by LegCo in 1975 and 1991 to authorize the Government to borrow generally. The proposed resolution would enable the Administration to proceed with the proposal with experts engaged to achieve the best deal when market conditions permitted.

VI. Agreement between the Hong Kong Special Administrative Region of the People's Republic of China and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital

(LC Paper No. CB(1)671/03-04(04) — Paper provided by the Administration)

56. Upon the invitation by the Chairman, DS/FST(T) briefed members on the comprehensive agreement for avoidance of double taxation (CDTA) between Hong Kong and Belgium, and the Administration's plan to enact legislation to give effect to the agreement. DS/FST(T) pointed out that the Agreement between the Hong Kong Special Administrative Region and the Kingdom of Belgium for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital, which was signed on 10 December 2003, was the first CDTA concluded by Hong Kong with another economy. The Agreement sought to eliminate double taxation instances encountered by Hong Kong and Belgian investors and employees in connection with cross border economic activities. In addition to the actual tax savings for taxpayers of Belgium and Hong Kong, the Agreement would achieve the following benefits:

(a) It would provide a further level of certainty and stability to potential investors, as the allocation of taxing rights between Hong Kong and Belgium as well as the relief regarding/limits on tax rates on the different types of income were set out clearly in the bilateral agreement so that subsequent unilateral tax policy changes would not override the terms of the Agreement; and

(b) The formal relationship and dialogue established with the Belgian tax authorities as provided under the Agreement could be used to resolve difficulties which might arise in connection with cross-border taxation.

57. DS/FST(T) further pointed out that as a whole, the Agreement would help investors better assess their potential tax liabilities from economic activities, foster closer economic and trade links between the two places, and provide added incentives for Belgian enterprises to do business/invest in Hong Kong, and vice versa. To give effect to the Agreement, the Administration was preparing an order under section 49 of the Inland Revenue Ordinance (Cap. 112). Such an order was subsidiary legislation and would be subject to negative vetting of LegCo. The Agreement would take effect as from the beginning of the next tax year (1 April 2004 for Hong Kong taxes and 1 January 2004 for Belgian taxes), subject to the completion of ratification procedures for both sides.

58. The Chairman invited members' views on the Agreement. There being no questions from members, the Chairman thanked the Administration for briefing the Panel on the subject.

VII. Proposed changes to the directorate establishment of the Financial Services and the Treasury Bureau and Inland Revenue Department

(LC Paper No. CB(1)671/03-04(05) — Paper provided by the Administration)

Briefing by the Administration

59. Upon the invitation by the Chairman, PS/FST(T) briefed members on the proposed rationalization of the directorate establishment in the Financial Services and the Treasury Bureau (FSTB) and the Inland Revenue Department (IRD) with effect from 1 April 2004 to better meet government policy objectives. The proposed changes were summarized as follows:

(a) To delete a directorate post (D2) in the Treasury Branch (TB) of FSTB;

(b) To delete a directorate post (D1) in IRD;

(c) To upgrade a directorate post (from D3 to D4) in TB of FSTB;

(d) To create a directorate post (D2) and redistribute the duties of four directorate posts (D2) in the Financial Services Branch (FSB) of FSTB; and

(e) To redeploy a directorate post (D1) within FSTB and a directorate post (D2) within IRD.

60. PS/FST(T) added that after the proposed rationalization, there would be a net deletion of one directorate post. The Administration planned to submit the proposals to the Establishment subcommittee on 11 February 2004.

Discussion

61. On the proposed creation of a directorate post in FSB, Mr Henry WU noted from paragraph 16 of Appendix 1 of the paper that the Administration had considered but rejected the option of creating a supernumerary post because a time-limited post could not cope with the workload on an on-going basis. Mr WU considered that in line with the usual practice, the Administration should create a supernumerary post before the need for a permanent post was established.

62. In response, the Permanent Secretary for Financial Services and the Treasury (Financial Services) (PS/FST(FS)) explained that the workload of the existing four Principal Assistant Secretaries (PASs) in FSB had increased to a level that due degree of attention could not be accorded to new policy initiatives. As a stop-gap measure, an officer had been seconded from the Hong Kong Monetary Authority to FSB since December 2002 to perform the policy functions at a PAS level. However, FSB could not rely on this temporary arrangement to provide support for the additional long-term workload. A recent internal establishment review had concluded that given the increased complexity of the policy and legal issues involved, the existing four PASs were unable to absorb the additional workload. It was therefore proposed that a new PAS post be created on a permanent basis. With the proposed fifth PAS post, the allocation of duties among the existing four PASs in FSB would also be rationalized to enhance synergy. PS/FST(FS) also pointed out that despite the creation of the PAS post, the establishment proposals mentioned in paragraph 59 above would achieve overall net savings.

63. At the invitation of the Chairman, the Clerk informed members that Mr James TIEN had given a note to the Chairman before he left the meeting, stating that Members of the Liberal Party were in support of the establishment proposals. The main reason was that the proposals would generate overall net savings of $966,060 in terms of notional annual salary cost at mid-point.

VIII. Any other business

(LC Paper No. CB(1)671/03-04(06) — Paper prepared by the Research and Library Services Division)

Proposed research outline on management of Government investment incomes

64. The Chairman referred members to the paper prepared by the Research and Library Services Division of the LegCo Secretariat and invited members' views on the proposed research outline on management of Government investment incomes. There being no comments from members, the research outline was endorsed by the Panel.

65. The Chairman advised that the full research report was expected to be completed by April/May 2004.

66. There being no other business, the meeting ended at 12:35 pm.

Council Business Division 1
Legislative Council Secretariat
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