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**Paper for the House Committee meeting
on 29 April 2005**

**Report of the Subcommittee to Study
the Eastern Harbour Crossing Ordinance
(Amendment of Schedule) Notice 2005**

Purpose

This paper reports on the deliberations of the Subcommittee to Study the Eastern Harbour Crossing Ordinance (Amendment of Schedule) Notice 2005.

Background

2. Section 55(3)(a) of the Eastern Harbour Crossing Ordinance (the EHC Ordinance) (Cap. 215) provides that the tolls specified in the Schedule to the EHC Ordinance may be varied by agreement between the Chief Executive-in-Council and the tunnel company. If an agreement cannot be reached, section 55(3)(b) provides that either party may submit the question of the variation of tolls to arbitration under the Arbitration Ordinance (Cap. 341).

3. In August 2003, the New Hong Kong Tunnel Company Limited (NHKTC), franchisee of the EHC, commenced arbitration against the Government's decision for rejecting its toll increase application for a \$5 increase in tolls for private cars and corresponding increases for other types of vehicles with effect from 1 January 2003. In the arbitration, NHKTC sought a \$10 increase in tolls for private cars and taxis, with corresponding increases for other types of vehicles with effect from 1 January 2005.

4. In January 2005, the arbitrators¹ determined that the tolls for private cars and taxis should be increased by \$10 to \$25 with corresponding increases for other types of vehicles. The new tolls should come into effect as from 1 May 2005.

¹ In the arbitration, the Government and NHKTC appointed their own arbitrator. With the consent of the two parties, the two arbitrators nominated another Queen's Counsel in London as Umpire.

EHC Ordinance (Amendment of Schedule) Notice 2005

5. On 18 March 2005, the EHC Ordinance (Amendment of Schedule) Notice 2005 (the Notice) was published in the Gazette under section 55(6) of the EHC Ordinance. The Notice seeks to amend the Schedule to the EHC Ordinance to vary the EHC Road Tunnel tolls pursuant to the arbitration award.

The Subcommittee

6. The House Committee agreed at its meeting on 1 April 2005 to form a Subcommittee to study the Notice. Chaired by Hon LAU Kong-wah, the Subcommittee held three meetings to discuss the Notice with the Administration. The Subcommittee also met with NHKTC and Dr Raymond SO, Associate Professor, Department of Finance, the Chinese University of Hong Kong, who gave views on the calculation of the rate of return on equity. The membership list of the Subcommittee is in **Appendix I**.

Deliberations of the Subcommittee

7. The Subcommittee is very disappointed at the magnitude of the toll increase which does not take into account the prevailing economic conditions, the affordability of the general public, and the sentiments of the community. Members of the Subcommittee are gravely concerned about the substantial increase in the EHC tolls and the resultant economic and traffic implications. The EHC toll increase may induce public transport operators and the trucking industries to raise the fares of public transport services and delivery charges, hence adding to the financial burden of the public and the business sector. There is also concern that the EHC toll increase would aggravate the traffic congestion at the Cross-Harbour Tunnel and its surrounding areas and approach roads. As such, members consider that there is an urgent need to address the problem of uneven distribution of traffic amongst the three road harbour crossings; otherwise the community as a whole will have to bear substantial social and economic costs.

8. In the course of deliberations, the Subcommittee has examined the following major issues:

- (a) the extent of LegCo's power to amend or repeal the Notice;
- (b) Government's handling of toll increase applications from the tunnel company and actions taken to mitigate the impact of the EHC toll increase on the community;
- (c) the approach and appropriate yardstick for measuring reasonable but not excessive remuneration under section 55(4) of the EHC Ordinance; and

- (d) the longer term measures to address the uneven distribution of traffic among the three road harbour crossings.

Extent of LegCo's power to amend or repeal the Notice

9. Given the magnitude of the toll increase determined by the arbitrators which amounts to almost 67% increase for private cars, the Subcommittee has studied how far LegCo can amend the Notice.

10. The Notice to amend the toll schedule of the EHC is subject to the negative vetting procedure and it shall come into operation on 1 May 2005. According to section 34(2) of the Interpretation and General Clauses Ordinance (Cap. 1), LegCo's power to amend subsidiary legislation has to be consistent with the power to make such subsidiary legislation. The power of the Commissioner for Transport to make the Notice is restricted by section 55(5) and (6) of the EHC Ordinance and does not cover the determination of toll levels and the timing for implementation of the new tolls. As such, the power of Members to amend this Notice is similarly restricted. In other words, there is little room for Members to amend the Notice other than making minor technical amendments. Similarly, LegCo cannot repeal the Notice as the exercise of such power is also inconsistent with the power of the Commissioner for Transport to make the Notice. The Subcommittee also notes that the outcome of the arbitration is final in the absence of an appeal and amendments to the statutory tolls in the Schedule can only be made if there is a new agreement between the Government and NHKTC after further negotiation.

11. In the course of deliberation, members noted that the Government did not lodge an appeal against the arbitrators' Award. The public was not aware of the arbitrators' Award until 11 March 2005. Queries had been raised as to why the Administration only released information on the arbitrators' Award after the expiry of the appeal period. In this respect, the Administration explained that it was the duty of the Government to decide whether an appeal should be lodged against the arbitrators' Award. In the NHKTC case, upon receipt of the Award on 26 January 2005, the Administration had actively considered whether the Government should lodge an appeal and in the meantime discussed with NHKTC to see whether and how the magnitude of the toll increase could be reduced. These courses of actions took time. The Administration had then reported to LegCo on 18 March 2005 on the matter with comprehensive information on, inter alia, the courses of actions it had taken and its decision with regard to lodging an appeal against the Award or otherwise.

12. The Administration also advised that in considering whether to appeal against the arbitrators' Award, the Department of Justice (DoJ) had sought advice from the two Leading Counsel on whether there was ground for appeal and the merits of an appeal against the Award. The two Leading Counsel jointly advised that there was no reasonable prospect of a successful appeal, and DoJ agreed with their views. The Administration therefore decided not to appeal.

13. Referring to the commencement of the EHC toll increase, members questioned the Administration for not honouring its undertaking made at the meeting of the Transport Panel on 18 March 2005 to defer the gazettal of the Notice, pending further consideration by NHKTC on the magnitude and timing for implementation of the EHC toll increase. The Administration explained that on 18 March 2005 when the Administration attended the Panel meeting, the Notice had already been published in the Gazette and distributed to the general public. The gazettal of the Notice was a statutory duty required under the EHC Ordinance. When the Administration said it was prepared to consider the gazettal arrangement if a more favourable outcome could be reached between the Government and NHKTC after the Panel meeting, it was referring to a possible subsequent gazettal to repeal or amend the Notice published on 18 March 2005. The Administration had no intention to mislead LegCo, and apologized for the misunderstanding so arisen.

Government's handling of toll increase applications

14. The Subcommittee noted that in respect of EHC, there had been two arbitrations conducted: one in 1997 and one in 2005. In the 1997 Arbitration, the arbitrator ruled that the band of reasonable remuneration for NHKTC was an internal rate of return (IRR) between 15% and 17% over the life of the franchise, and that the tolls for private cars and taxis were allowed to be increased by \$5, with corresponding increase for other types of vehicles as from 1 January 1998. In the 2005 Arbitration, although the arbitrators did not consider that the 1997 Arbitration was binding on them, they found that in the absence of persuasive evidence to the contrary, it was both practical and fair to the parties and the public that the conclusions of the 1997 Arbitration should be given weight. On this basis and having considered the matters set out in section 55(4) of the EHC Ordinance, the arbitrators concluded that the reasonable level of remuneration for NHKTC remained as was decided in the 1997 Arbitration.

15. Whilst recognizing the need to respect the rule of law and hence the decision of the arbitrators, some members of the Subcommittee are of the view that the Administration has failed to formulate a policy to address the relevant issues since the 1997 Arbitration. There is apparently a difference in opinion between the Government and the tunnel company over the acceptable IRR. Instead of adopting a more pragmatic approach in reaching an agreement with the tunnel company on the magnitude of the toll increase, the Government had rejected the EHC toll increase application in 2003. As a result, the matter had to be resolved through arbitration where the outcome might vary from one arbitrator to another.

16. The Administration's explanation is that the EHC Ordinance does not provide the detailed criteria for determining toll adjustments. It only stipulates that if the matter is submitted for arbitration, the arbitrators shall be guided by the need to ensure that the carrying out by the tunnel company of its obligation, or the exercise of its rights, under the EHC Ordinance is reasonably but not excessively remunerative to the

tunnel company, having regard to, inter alia, any material change in the economic conditions of Hong Kong since the enactment of the EHC Ordinance or, as the case may be, since tolls were last determined. As the band of reasonable but not excessive remuneration determined in the last arbitration is neither fixed nor immutable, the Administration is of the view that it would be up to each party to submit evidence and present its case in the event of arbitration.

17. Some members also criticized the Government for its lack of vigorous actions to negotiate with the tunnel company with a view to mitigating the impact of the toll increase from the present arbitration (2005 Arbitration). In this connection, the Administration advised the Subcommittee that it had approached NHKTC after the arbitration to explore the possibility of reducing the actual level of increase, deferring the effective date of the increase or implementing the new tolls by stages. After negotiation, NHKTC had agreed to the following:

- (a) toll increases for all vehicles (except light buses and empty taxis) to be deferred to 1 May 2005;
- (b) toll increase for empty taxis to be deferred to 1 July 2005; and
- (c) toll increase for light buses to be deferred to 1 October 2005.

Approach and appropriate yardstick for measuring the remuneration for NHKTC

18. The Subcommittee notes that the Administration and NHKTC have adopted the IRR on equity for calculating the rate of return for NHKTC. However, Dr Raymond SO, Associate Professor, Department of Finance, the Chinese University of Hong Kong, holds a different view and suggests that another approach should be used to assess the rate of return on equity. The Subcommittee notes that application of different approaches for calculation would give rise to different rates of return, and hence, the need and magnitude of the EHC toll increase.

19. The IRR on equity approach is based on the cashflows to investors over the franchise period and takes into account the time value of money. According to NHKTC, the IRR on equity was 8.4% up to the end of 2003.

20. Regarding the approach suggested by Dr Raymond SO, it looks at the cumulative profit as a proportion of the share capital. With a share capital of \$750 million and a cumulative profit (up to year 2003) of \$ 2 500 million, the overall return rate on equity for the past 17 years was already 333% or 19.6% per annum. On a single year basis, Dr SO pointed out that NHKTC's profit for 2003 amounted to some \$250 million and the return rate on equity for the year was 33%. Applying this rate of return to the remaining franchise period, the return rate on equity for the next 11 years would be 363% assuming that the income and expenditure sides of NHKTC remained more or less the same as in previous years. Given the high return rate, there was no strong justification for the company to increase the tunnel tolls. Dr SO also cast doubt that the company had retained an unreasonably high level of profit without

distributing it to shareholders so as to suppress the return to shareholders in the past years in return for a higher rate of toll increase.

21. Given the wide public concern over the appropriateness of using IRR on equity as a yardstick for determining the rate of return for NHKTC, and hence, the level of toll increase, the Subcommittee has examined the subject matter in detail.

22. The Subcommittee noted that it was common ground between the Administration and NHKTC that an appropriate yardstick for measuring the rate of return for a company engaged in a Build-Operate-Transfer (BOT) project was its IRR on equity after tax over the life of the franchise. In the 1997 Arbitration, the Government and NHKTC, as well as their expert consultants, agreed that the IRR on equity over the life of the franchise was an appropriate yardstick to measure the reasonableness of the remuneration of a company engaged in a BOT project. To ensure the reliability and accuracy of the financial data, the Administration has regularly checked the financial data of NHKTC and found them to be in order.

23. NHKTC pointed out that IRR necessitated looking at cashflows paid and received throughout the project as well as the timing of such flows. Simply put, \$1 paid or received in 1986 was not equivalent to \$1 paid or received in 2005. Therefore a capital sum of \$750 million – the capital of EHC – in 1986 would be equivalent today to a considerably higher sum than \$750 million. To measure returns achieved today against a capital sum in 1986 without adjusting for the time value of money was misleading and significantly distorted the true returns actually achieved.

24. As regards the reasons for NHKTC to maintain a relatively high level of retained earnings in the accounts, NHKTC pointed out that this was because the consortium behind EHC had been restricted by the loan agreement with the lending banks for payment of dividends from retained earnings until such bank loans had been repaid in full. NHKTC had actually distributed all its surplus cash to shareholders after it repaid its loan in 2001. NHKTC simply did not have any extra cash to pay more dividends because most of the cash earned in the first 15 years of the project was used for repaying the loan that partially financed the building of the tunnel. As such, the alleged manipulation of financial data and use of financial management techniques by NHKTC for achieving a higher rate of toll increase was incorrect and totally unfounded.

25. Regarding Dr SO's suggestion that NHKTC should obtain loans to pay increased dividends at an early stage so as to increase the IRR on equity, NHKTC pointed out that debt should only be used to finance cash generative assets. Borrowing to pay dividends was not prudent financial management. Moreover, additional finance costs would ultimately be borne by EHC's customers.

26. As for the band of reasonable remuneration, the Subcommittee has also examined the difference in opinions between the Government and the tunnel company over the acceptable IRR as well as the yardsticks for measuring "reasonable but not excessive" remuneration under section 55(4) of the EHC Ordinance.

27. Notwithstanding the ruling in the 1997 Arbitration that the band of reasonable remuneration for NHKTC was an IRR between 15% and 17% over the life of the franchise, the Government has held the view that it should be adjusted downward to an IRR of 12-14% having regard to the adverse changes in the economic conditions of Hong Kong since 1997. Based on the traffic projection of EHC made by the respective traffic experts of the Government and NHKTC, the IRR for a “no toll increase” scenario would be 13.64%. The Administration had thus considered that there was no justification for a toll increase and rejected NHKTC’s application in July 2003.

28. However, both the tunnel company and the arbitrators consider that the band of reasonable remuneration for NHKTC should remain 15-17% as the changes in the economic conditions of Hong Kong since the tolls were last determined in the 1997 Arbitration are not “material”. Under the circumstances, some members are of the view that given the determinations on the band of reasonable band of remuneration in the two arbitrations, the Administration might need to adopt a more pragmatic approach by using a higher IRR as the basis for its further negotiation with the tunnel company on viable measures to even out the traffic flow among the three road harbour crossings. To avoid uncertainty, it is still more desirable for the Administration to reach an agreement with the tunnel company on the magnitude of toll increase rather than resorting to arbitration. The Administration should also review the acceptable band of reasonable remuneration in collaboration with the tunnel company.

Measures to even out the distribution of traffic among road harbour crossings

29. The Subcommittee anticipates that the Cross-Harbour Tunnel and its approach roads will become more congested after the new tolls of the EHC have taken effect. The Subcommittee has urged the Administration to put in place adequate measures to address the traffic disruptions which may result in chaos

30. On short term measures to address the problem, the Subcommittee notes that the Administration will make announcements before 1 May 2005 to encourage the public to use public transport and to avoid using the Cross-Harbour Tunnel during peak hours as far as possible. The Transport Department will activate the Emergency Transport Co-ordination Centre to closely monitor the traffic and transport conditions. The Administration will take appropriate measures to tackle the traffic problems arising from the toll increase.

31. On the longer term measures to alleviate the problem of uneven distribution of traffic among the three road harbour crossings, the Subcommittee notes that the Administration is examining the subject matter. The Transport Panel was also briefed on 22 April 2005 regarding the proposed measures to address the problem. As the wider issue of the problem of uneven distribution of traffic among the three road harbour crossings falls outside the purview of the Subcommittee, members agree that it is more appropriate for the Panel on Transport to follow up the related issues.

Deferral of the toll increase

32. The Subcommittee has urged NHKTC to consider deferring the toll increase. Meanwhile the Government and the tunnel company should expeditiously review the toll levels of the three cross-harbour tunnels taking prudent consideration of the interest of the general public with a view to improving the uneven distribution of traffic among the three tunnels.

33. NHKTC has pointed out that the company had already made an effort to defer the toll increase for one month to 1 May 2005. The company has to look into the longer and wider view of the situation. The company therefore considers that the consequence of a further deferral of the toll increase would be that a future increase will be higher when it comes. Further deferral simply does not serve the long-term interest of the users of EHC.

Motion

34. At the Subcommittee meeting on 28 April 2005, the Subcommittee passed the following motion:

『本小組委員會強烈譴責新香港隧道有限公司漠視民生大幅加價，並呼籲新香港隧道有限公司盡快與政府達成協議，在未達成協議前，本小組委員會要求新香港隧道有限公司押後加價。』

“That this Subcommittee strongly reprimands the New Hong Kong Tunnel Company Limited for substantially increasing the tolls of the Eastern Harbour Crossing in disregard of people’s livelihood, and calls on the company to expeditiously reach an agreement with the Government; this Subcommittee requests the company to defer its toll increase before such an agreement is reached.” (translation)

35. In the course of debate, views had been expressed that whilst the Arbitrators’ Award was not welcomed by the general public, it was an outcome of due process in full compliance with law. As such, it might not be appropriate for the Subcommittee to reprimand the company for substantially increasing the tolls of the EHC. LegCo was also not in a position to alter the decision of the Arbitrators.

The Way Forward

36. In view of the limited power which LegCo can exercise in respect of the Notice, the Subcommittee considers that it will not pursue the matter further. It however urges the Administration to closely liaise with NHKTC with a view to deferring the toll increase and coming up with a proposal to resolve the uneven distribution of traffic

among the three road harbour crossings. The Subcommittee also recommends that the Transport Panel should continue to follow up on the related issues.

Advice sought

37. The Subcommittee invites the House Committee to note its deliberations.

Council Business Division 1
Legislative Council Secretariat
29 April 2005

**Subcommittee to Study the Eastern Harbour Crossing Ordinance
(Amendment of Schedule) Notice 2005**

Membership list

Chairman	Hon LAU Kong Wah, JP
Members	Hon LEE Cheuk-yan Hon Fred LI Wah-ming, JP Hon Mrs Selina CHOW LIANG Shuk-ye, GBS, JP Hon CHAN Kam-lam, JP Hon Miriam LAU Kin-ye, GBS, JP Hon Emily LAU Wai-hing, JP Hon Andrew CHENG Kar-foo Hon LI Fung-ying, BBS, JP Hon WONG Kwok-hing, MH Hon Jeffrey LAM Kin-fung, SBS, JP Hon LEUNG Kwok-hung (Total : 12 Members)
Clerk	Mr Andy LAU
Legal Adviser	Ms Connie FUNG
Date	12 April 2005