Legislative Council Panel on Transport
Subcommittee on matters relating to railways

Disneyland Resort Line – Financing Arrangements

Introduction

At the Subcommittee meeting held on 6 May 2005, members requested for further information on the financing arrangements of the Disneyland Resort Line (DRL) project. The Environment, Transport and Works Bureau has consulted the Financial Services and the Treasury Bureau and the Administration's response is as follows.

Background

2. In July 2002, the Subcommittee on Matters Relating to Railways held four meetings to discuss the arrangement for DRL (formerly known as "the Penny's Bay Rail Link"), including the financial arrangements, the basis of the capital cost estimate and revenue assumptions, as well as the principles behind Government's dividend waiver as funding support for DRL. A copy of the relevant information paper setting out details of the financial arrangement which had been issued to the LegCo Panel on Transport in 2002 is attached at Annex (Annex B of this attachment is not enclosed).

Government's justifications in providing funding support to MTRCL

3. Organizations operating on commercial principles must ensure that an investment can earn a commercial rate of return before committing to it. In arriving at its decision to provide a financial support of $798 million to MTRCL's DRL project, the Government has made a thorough check on the assumptions provided by the Corporation, which include a review of the market environment, patronage and market share estimates, project cost estimates and incremental revenue for the MTR system.

4. The estimated project cost of the DRL project is $2 billion (in money-of-the-day prices). As defined in the prospectus for the initial public offering, the commercial rate of return required by MTRCL on its new railway projects should be between 1% and 3% above its weighted average cost of capital. According to MTRCL's financial assumptions - a projected attendance of around 5.5 million visitors to the Hong Kong Disneyland Theme Park in the first year of operation, a projected total market share of around 30 to 40% for DRL, and that a one-way fare from Sunny Bay to the Theme Park is between $5 and $7.5 – the return of the DRL project is below the required commercial rate of return. The Corporation's financial assessment has already taken into account additional fare revenues induced by increased patronage travelling in the rest of the MTR system resulting from the DRL, as well as station commercial revenues.

5. Starting from 2002, the Government has gradually waived its claim for $798 million (at net present value on 1 January 2002) of dividends otherwise payable by MTRCL to Government as a shareholder. The waiver of dividend was completed in 2004.

Risks assumed by MTRCL

6. On 24 July 2002, the Government entered into a legally binding Project Agreement with the MTRCL for the financing, design, construction and operation of the DRL. As soon as the Project Agreement was signed, the Corporation assumes all the commercial risks relating to the project, including project cost overrun and project delays due to unforeseen circumstances, economic risk, market risk and operational risk for the life of the project.

7. Should DRL underperform, MTRCL has no recourse to the Government for additional financial support. On the other hand, if DRL's performance turns out to be better than expected, any such benefit will go to its shareholders, including the Government. In any event, the actual parameters of the project, including the fare revenues and the internal rate of return, will not be available until the end of the franchise period.

Fares

8. As an extension of the MTR system, DRL follows the existing fare structure. In considering the fares, MTRCL has taken into account factors including the economic situation, operating condition, public affordability, market competition as well as the nature of the trips, with a view to providing value for money service to passengers. The one-way Octopus and single-ride fares for journeys between Sunny Bay Station and Disneyland Resort Station are $5.6 and $6 respectively, which match with the previous fare assumption. Details of the DRL fares were set out in the information paper presented to the Subcommittee in April 2005.

9. As a listed company, it should be MTRCL's responsibility to ensure its services are financially sound and to operate under prudent commercial principle. The Government has also been encouraging the Corporation to take into account a host of factors such as those mentioned in paragraph 8 above in deciding the DRL fares and to introduce promotional offers as and when appropriate.

Environment, Transport and Works Bureau
June 2005

Annex

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Legislative Council Panel on Transport

Subcommittee on matters relating to the implementation of railway development projects

MTR Penny's Bay Rail Link – Project Agreement

INTRODUCTION

At the special meeting of this subcommittee held on 9 July 2002, we briefed Members on the draft Penny's Bay Rail Link (PBRL) Project Agreement as approved by the Executive Council on the same day. Members requested additional information in relation to the Project Agreement and the funding arrangement of the PBRL project. The information is set out as follows :-

FINANCIAL ARRANGEMENTS

Need to Provide Financial Support to MTRCL

2. The $798 million financial support to be provided to MTRCL in the form of waived dividends has been estimated based on a thorough check on MTRCL's assumptions. Patronage and cost items assumed are in line with our own forecast and MTRCL's historical trend. Our financial advisors also checked MTRCL's financial assumptions and advised that they are reasonable.

MTRCL as a Commercial Entity - Undertaking during the Initial Public Offering in 2000

3. When MTRCL was privatised in 2000, the Government undertook in the Initial Public Offering Prospectus for MTR Shares and in its Operating Agreement with MTRCL that the Government would not require the company to construct and operate any future railway project without its agreement. The Government also recognised that MTRCL would require an appropriate commercial rate of return on its investment in any new railway projects, which is considered to be between 1% and 3% above the estimated weighted average cost of capital (cost of capital) of the company. This undertaking is important in maintaining MTRCL's financial standing and prospects.

Assessment on the Financial Viability of PBRL

Methodology

4. A project is considered not financially viable if the present value of revenues net of operating expenditures falls short of the capital expenditures. For PBRL, all its revenues net of operating expenditures over the franchise period are estimated and then discounted to derive the present value and the estimated capital expenditure including asset replacement costs is then deducted from this present value. Because the capital expenditure is higher than the present value, the shortfall is regarded as a "funding gap" and it is estimated to be $798 million.

Revenue Assumptions

5. MTRCL's patronage assumption is based on a projected attendance of around 5.5 million visitors to the Hong Kong Disneyland (HKD) in the first year of operation in 2005/06, a projected total market share of around 30-40%, and a one-way fare from Yam O to HKD which is assumed to be set at a competitive level of less than $10. The financial assessment also takes into account extra fare revenue from increased patronage induced by the PBRL. Since patronage and revenue of the PBRL are commercially sensitive to MTRCL, we are unable to divulge more information. As a publicly-listed company on the Stock Exchange of Hong Kong, MTRCL has a duty to safeguard its commercial and financial information as its disclosure may prejudice MTRCL's position with third parties.

Capital Cost

6. As regards capital cost, the Government has through several rounds of negotiations with MTRCL successfully agreed a reduction from the initial estimate of $2.6 billion to $2.0 billion. This has taken into account the current economic situation, the recent deflationary trend, various cost-saving measures initiated by MTRCL and we are satisfied that it is a realistic estimate of the construction cost. The main categories of the capital costs are -

Cost Items	$ (million) (money-of-the-day prices)
Capital Costs	1,872
Capitalised interest	106
Total	1,978

Estimated Project Internal Rate of Return

7. The project internal rate of return (PIRR) at 11.25% is pitched in the range between 1% and 3% above the cost of capital as mentioned in paragraph 3 above. This is estimated based on the weighted average of MTRCL's cost of debt and cost of equity, and is comparable with the PIRRs of other infrastructure projects such as toll tunnels.

8. Equity investors expect a commercially-run corporation such as MTRCL to earn a return that can at least cover its cost of capital. The cost of capital of a company is comprised of its cost of debt and cost of equity and is also affected by its capital structure, i.e. how much the company borrows in relation to its shareholder funds. The cost of borrowing is linked to the US Treasury bond yield plus a risk factor based on the company's credit ratings. If one compares the project return of 11.25% with this alone, one may conclude that the return is on the high side given the present low interest rate environment. This conclusion would be incorrect for two reasons, the first being that the current low-interest rate environment will not necessarily prevail through the life of the project. To complete the picture, one must also take into account the cost of equity in determining whether the return is reasonable. The cost of equity of a commercial entity is usually higher than the cost of debt. This reflects the risk of the stock market and also the risk of doing business. It is the return that an equity investor would expect to receive. It is not unilaterally set by anyone, but it depends very much on the stock market and how investors view a company. Over the past ten years, the return on equity on the Hang Seng Index has been on average around

13.5% per annum.

9. Add the cost of equity to the cost of debt on a weighted basis and we get the cost of capital of a company. We should compare that cost of capital plus an appropriate risk factor having regard to the inherent business risks of such a project, with the project return. It is what the investment community does and it would only be meaningful to compare the 11.25% project return with this. Cost of capital is a commercially sensitive information to a listed company. Therefore, we are unable to divulge MTRCL's cost of capital here.

DIVIDEND WAIVER AS FUNDING SUPPORT : PRINCIPLES

10. The principle is that we should preserve the financial autonomy of MTRCL as a commercial entity. On this basis, we will not subsidise any railway project proposed by the two railway corporations which are run on commercial principles. Subsidy is a cost to the Government on which we may never see a return. Funding support through a dividend waiver, however, is different from subsidy. It is not a cost to the Government but should be treated as retention and enhancement in value of the Government's investment.

11. The Government will consider each request for funding support on its own merits and we would only provide this if we see substantial economic benefit. There is no "one-size fits all" solution. In this case, the PBRL is essential to the opening of the HKD as it will provide a principal gateway to the theme park, conveniently linked to other parts of

the territory. As estimated, the net economic benefit of the HKD to the whole economy is around $148 billion.

12. We have considered the option of granting property development rights at Yam O to MTRCL as funding support. However, due to engineering, planning and other land use restrictions, this option is not feasible. Equity injection into MTRCL was considered but it was decided that this would not be useful given that any further equity injection into MTRCL will itself require a return and therefore not improve the project financial viability. This would adversely affect MTRCL's cost of doing business and its competitiveness. This leaves dividend waiver the most appropriate option.

13. As with granting property rights to MTRCL, the dividend waiver option can preserve MTRCL's financial autonomy. Property development is not without risks and it is not free. We demand land premiums at full market value from MTRCL. Dividend waiver bears resemblance to the grant of property development rights since the declaration of dividend, like property development, is under MTRCL's control. To bridge the funding gap, MTRCL is incentivised to deliver profits and hence declare dividend. In comparison, any capital grant by the Government will be viewed as subsidy and MTRCL will not be incentivised to perform since there is no need to repay the capital grant.

INFORMATION ON DIVIDENDS WAIVED IN THE PAST FOR OTHER GOVERNMENT-OWNED CORPORATIONS

14. Information on the declaration of dividends of the three major Government-owned corporations i.e. MTRCL, Kowloon-Canton Railway Corporation and the Airport Authority is attached at Annex A.

SUSTAINABILITY IMPACT ASSESSMENT REPORT OF PENNY'S BAY RAIL LINK

15. Sustainability assessment assesses the potential impact of the proposed rail link on the economic, environmental and social conditions of Hong Kong from a territory-wide perspective. A copy of the sustainability assessment report is attached at Annex B.

Annex B not enclosed

16. Since the rail link is an integral part of the overall Disney Park project, in conducting the sustainability assessment of the PBRL, the Administration took note of the fact that an Environmental Impact Assessment (EIA) study for the HKD and its associated infrastructure including the construction and operation of the PBRL was completed in March 2000. In essence, the EIA stated that all these works would meet the established environmental standards and legislation after the implementation of the recommended mitigation measures during the construction and operation stages. The EIA report was endorsed with conditions by the Advisory Council on the Environment on 17 April 2000 and approved by the Director of Environmental Protection on 28 April 2000 under the Environmental Impact Assessment Ordinance. MTRCL

will comply with all the conditions in the relevant environmental permits for the construction and operation of the PBRL. Environmental monitoring and audit programmes will be put in place.

17. Another important consideration is the economic significance of HKD. The PBRL is an essential element of the associated infrastructure in support of the HKD development which will provide an efficient and environmentally friendly means of transportation to and from HKD.

Environment, Transport and Works Bureau
12 July 2002

Annex A

Cash dividend received from MTR Corporation Limited or Mass Transit Railway Corporation

Dividend for year	Amount of Dividends ($ million)
Prior to 1996	Nil
1996	647
1997	1,252
1998	Nil
1999	Nil
2000	153
2001	688

Cash dividend received from Kowloon-Canton Railway Corporation

Dividend for year	Amount of Dividends ($ million)
1990	125
1991	140
1992	150
1993	160
1994	Nil
1995	Nil
1996	300
1997	Nil
1998	Nil
1999	Nil
2000	Nil
2001	Nil

Cash dividend received from Airport Authority

Dividend for year	Amount of Dividends ($ million)
1998-99	Nil
1999-2000	Nil
2000-01	Nil
2001-02	Nil