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Hong Kong SAR Legislative Council Rail Merger Bill

Written Views by

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I thank the Bill Committee on Rail Merger Bill of the Hong Kong SAR Legislative Council for inviting me in a letter dated August 18, 2006, to provide a written view on the merger of the Mass Transit Railway (MTR) and the Kowloon-Canton Railway Company (KCRC). My written views are based on the papers on "Legislative Council Panels on Transport and Financial Affairs, Merger of MTR and Kowloon-Canton Railway Systems – Proposed Way Forward" [LC Paper No. CB(1)1291/05-06(01)], and "Legislative Council Brief – Rail Merger Bill" [ETWB(T)CR 1/986/00]. I will concentrate my views on the areas of economics of merger, financial package given in the proposal, the Rail Merger Bill and the restructuring of the Hong Kong economy.

The Merger of MTR and KCRC: Concern of the Increase in Monopoly Power

Being a small and open economy with an attitude on "large market, small government", infrastructure provision in Hong Kong is largely conducted by the government while the provision of public utilities is often shared between the public sector and the private sector. The role of the Hong Kong government in the provision of public utilities has often focused on equity grounds, ensuring an effective supply, stability and affordability in price and environmental requirements.

Since many public utilities in Hong Kong are provided by one or two companies, the public concern is the potential monopolistic power exercised by the few suppliers. Public scrutiny and effective control by the government and other relevant authorities, including the Legislative Council, play a crucial role. This has not been easy, depending on the nature of the source of monopoly. For example it would be more difficult to monitor if the monopoly power comes from foreign companies. All public utility companies face the dilemma of profit-making and the social role. The various parties in monitoring the market power of public utilities include the government, the public, civic authorities and the instituted system.

In the case of the two railway companies in Hong Kong, they do separately hold a certain degree of market monopoly already. Would a merger lead to a further increase in monopoly power? In theory, it would. But since each of them already has some degree of monopolistic power, there may not be further increases if there are effective rules and regulations governing their operation and public scrutiny on their policies and practices. In reality, it would be difficult for the merged company to exercise additional monopolistic market power in the railway transport business. As such, it would be more likely that the merger would provide more social benefits to Hong Kong, including as stated in the proposal, the reduction in fares and abolition of second boarding charge. The social benefit should be seen from a long term perspective, and be considered as an improvement in the overall transport infrastructure in Hong Kong.

The merger would allow MTR to diversify its investment in three areas: a) the newly merged company can plan railway development in the entire Hong Kong SAR; b) expands its business from transport to land acquisition and property development; and c) from railway provision in Hong Kong to future cross-border railway business. This should be welcomed as the new MTRCL would surely grow and become more efficient.

The Financial Package

The 50 years franchise granted to newly merged company is appropriate. In any financial arrangement that lasts for 50 years, there is no such thing as the “perfect” financial arrangement since a number of assumptions, such as the rate of future inflation, the supply of additional land for railway expansion and the increase in railway demand, will be made in the estimation. The financial package in the proposal does provide the amount the KCRC gets upfront and the stream of financial return during the entire franchise period.

The various assumptions used in estimating the financial proposal are not given, though one would presume they are sound and realistic. Although one can argue on the individual components, the overall proposal is acceptable and reflects the financial responsibility and benefits of different parties (MTR, KCRC and the public). The benefit that occurs to KCRC is given in paragraphs 23a-23d in the proposal. The upfront payment includes $4.25 billion for the service concession and the acquisition of various railway assets. This, however, is much smaller than the second payment that totaled $10.1 billion for the acquisition of property, related commercial interests and reimbursement. The future income for KCRC is the fixed annual payment of $750 million by MTR, which will not be inflation-adjusted, and the actual revenue shares will begin from the fourth year. The actual revenue shares ranges from 10% to 35% once the revenue exceeds $2.5 billion. These terms provides the KCRC a net present value that ranges between $30 billion to $56.5 billion. If there is any objection to these estimates, it should come from KCRC.

Since MTR will be the managing company after the merge, MTR will probably take a long term perspective, including the extension to property development, development of the railway industry in the entire Hong Kong and future cross-border potentials. Although the future financial benefits to MTR are not given in the proposal, one should hold an optimistic view on the future development and profit level of the merged company in future.

The benefits that occur to the general public are the other important dimension in the financial proposal. This is given in the section on the “Compliance with the five parameters” (paragraphs 4 – 17). The general attitude is always more is better than less. Firstly, the fare adjustment mechanism (FAM) that composes of changes in composite Consumer Price Index, the wage index and the productivity factor is similar elsewhere. In reality, one would expect little change in the fare, especially there is also a trigger mechanism of 1.5%. The advantage is that this provides overall price stability and transparency, though the FAM would be subject to a review every five years.

The abolition of the second boarding charge is a definite plus. However, whether the other price concessions (paragraphs 13a – 13e) are appropriate can be examined from the projected profit levels of MTR in the merger. The overall price concessions are mild and favor the long journal travelers more. The Legislative Council Panel on Transport and Financial Affairs could seek a more favorable price-reduction package or a promise of no fare increase for a period longer than 24 months following the signing of the Memorandum of Understanding (MoU) with the intention of providing additional price stability for the general public. For example, since the productivity factor would be set from the 6th year (paragraph 8), one can argue that price stability ought to be maintained in the first 5 years. Other parameters, such as the early resolution on the Shatin to Central Link and ensuring job security, are essential requirements.

The Rail Merger Bill

The Rail Merger Bill produces the legal framework, states and clarifies the responsibilities and functions of different parties. The three legal parties referred to in the Rail Merger Bill include MTR, KCRC and the SAR Government that represents the public interests, that include, in addition to the potential market power of the merged company, the allocation of land resources, the projected future development and quality of the railway industry and service provisions. More important, the SAR Government has to ensure that the instituted system that governs the operation of the merged company is effective, transparent and equitable.

Though the legality in the details of the Rail Merger Bill is the job of lawyers, the administrative responsibility of all parties should be spell out in as much detail as possible, as that should form the guideline the smooth, effective and efficient operation of the merged company in future. The successful application of the 50 years franchise relies considerably on the good governance of the administrative machinery and the administrators. I fully support the work of the Legislative Council Panel, especially the Chairman the Hon Miriam Lau Kin-yee, in instituting, checking and ensuring the incorporation of a good governance infrastructure in the specification of various details in the Rail Merger Bill.

Restructuring the Hong Kong Economy

My own analysis on the Hong Kong economy, which is published in a book “The Hong Kong Economy: Recovery and Restructuring” (McGraw Hill 2006), is that economic policies and strategies adopted in Hong Kong since the Asian financial crisis have been demand-driven that encouraged people to consume and spend, rather than supply driven that promotes growth in physical output.

The provision of all pubic utilities has a general and important role of maintaining a steady and stable economic survival cost. Charges on various public utilities have increased a lot over the years, leading to a high level of affordability. Since Hong Kong residents may not live close to their work, the cost of transport does have significant impact on their cost of living. A higher cost on basic necessities (food, clothing, housing and transport) will remove their overall purchasing power. Members of the legislative Council have the duty of overseeing the pace in the rise of the economic survival cost.

Among the various public utilities in Hong Kong, economic restructuring requires not only in improvements in operational efficiency, but improvement in the quality of the service in line with other social aspirations. One of the current social aspirations is environment and the reduction in pollution. The merger of MTR and KCRC may not lead to drastic changes in Hong Kong’s environment, but the merger of the two railway companies provides a good precedence to other public utilities. One example I have in mind is the possible merge of the bus company and the tram company in the Hong Kong Island, with the intention to have electric bus running on tram wire lines thereby replacing a large number of buses running along the tram routes. This will reduce both air pollution and traffic congestion. This certainly will be a longer term solution to improve pollution in the Hong Kong Island. Such a suggestion is innovative and can be practical if the two companies are willing to cooperate and merge with the initiative from the SAR Government. In conclusion, similar mergers in other public utilities can aid the economic restructuring process in Hong Kong.