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(Revised)

This submission is made in response to an invitation from the Legislative Council Committee on Rail Merger Bill.

Submission to the Legislative Council Committee on Rail Merger Bill

25th September 2006

Honourable Members, you are tasked with studying the Rail Merger Bill, introduced by the HKSAR Government in the context of a proposal to unite the operations (but not ownership) of the two rail networks of Hong Kong, the Mass Transit Railway owned and operated by MTR Corporation Ltd (**MTRC**, 0066) and the rail system owned and currently operated by Kowloon-Canton Railway Corporation (a statutory corporation wholly-owned by HKSARG).

I will not spend any time on the specific clauses of the Bill, but focus on the proposal from the crucial perspective of over 300,000 minority shareholders of MTRC, both institutional and retail, of which I am one, and also on the broader issue of the Government's transport policy and whether it is in the best interests of Hong Kong.

While a merger on the right terms would make commercial sense for MTRC, if the terms of the proposal are not substantially amended then I will lead a campaign urging my fellow minority shareholders to vote it down, because it is value-destroying. In short, this would derail the deal. I believe the HKSARG is wasting scarce legislative time by asking you to consider a Bill for a transaction which will be unacceptable to minority shareholders. I refer you to Webb-site.com for details of previous proposals by listed companies which I have successfully opposed to protect shareholder value.

At this stage, MTRC and Government have entered into a non-binding and confidential Memorandum of Understanding (**MoU**), so there is still time for them to amend the deal before they sign definitive agreements and put it to a vote.

There are 2 main reasons why independent shareholders are likely to vote against, and why I will recommend that they do so unless the deal is amended:

- MTRC would have to give up fare autonomy on most of its merged network and be bound by an "inflation minus X" formula, without receiving any payment for surrendering that autonomy; and
- MTRC would have to pay KCRC an ever-increasing percentage of the revenue from KCR assets, because thresholds in the formula for revenue-sharing will not be adjusted for inflation in the next 50 years.

In essence, the deal removes revenue upside from a potential market-based reform of transport policy and ensures a reducing profit margin, at a speed which depends on the future rate of inflation. As I will explain, the flaws result from the Government's socialist, subsidised, public transport policy which means that there simply isn't enough revenue to go around. If that is the long-term transport plan, then the Government should just admit it and buy out MTRC minority shareholders, rather than asking the company to give up its free-market potential.

Now let's deal with these issues in detail...

The revenue-sharing formula

The MoU provides that in return for the right to use existing KCR rail and rail-related assets, the MTR would pay, for the next 50 years, a share of revenue to KCRC as follows:

1. A flat payment of HK$750m per year, equivalent to 30% of the first $2.5bn of revenue.
2. 10% of any revenue from $2.5bn to $5.0bn
3. 15% of any revenue from $5.0bn to $7.5bn
4. 35% of any revenue above $7.5bn

The percentage payments would begin in year 4. Now based on revenue of $5,236m in 2005, as quoted in the MTRC presentation, the formula would result in a present payment of $1,035m, or 19.8% of the revenue. The catch, however, is that the thresholds continue unchanged until the end of a 50-year post-merger franchise, and inflation over time will push up the nominal revenue figure so that more and more revenue appears in the upper 35% band.

Taking a medium-case scenario of inflation of 5% per year for the next 50 years, which is in line with the current long-bond yield, the revenues would be $22.6bn 30 years from now, and $60.0bn by year 50. That's before allowing for any real revenue growth from the KCR assets under construction, namely the Kowloon Southern Link (**KSL**) and the Lok Ma Chau (**LMC**) Spur Link. They just make the problem worse, because they will push revenue into the 35% band sooner. And inflation, of course, could be a lot worse than 5%.

The table below shows you the range of nominal revenues depending on the rate of inflation:

Revenue after inflation

	After years					
Inflation	0	10	20	30	40	50
3%	5,236	7,037	9,457	12,709	17,080	22,954
4%	5,236	7,751	11,473	16,982	25,138	37,211
5%	**5,236**	**8,529**	**13,893**	**22,630**	**36,861**	**60,043**
6%	5,236	9,377	16,793	30,073	53,856	96,448
7%	5,236	10,300	20,262	39,858	78,406	154,237
8%	5,236	11,304	24,405	52,688	113,750	245,577
9%	5,236	12,396	29,345	69,470	164,460	389,336
10%	5,236	13,581	35,225	91,365	236,977	614,659

and as a consequence, the payments to KCRC, owned by Government, would be as follows:

Payment to KCRC	After years					
Inflation	0	10	20	30	40	50
3%	1,035	1,306	2,060	3,198	4,728	6,784
4%	1,035	1,463	2,765	4,694	7,548	11,774
5%	**1,035**	**1,735**	**3,612**	**6,670**	**11,651**	**19,765**
6%	1,035	2,032	4,627	9,276	17,600	32,507
7%	1,035	2,355	5,842	12,700	26,192	52,733
8%	1,035	2,706	7,292	17,191	38,562	84,702
9%	1,035	3,088	9,021	23,064	56,311	135,018
10%	1,035	3,503	11,079	30,728	81,692	213,880

which means that the revenue share payable to KCRC is as follows:

KCRC revenue share	After years					
Inflation	0	10	20	30	40	50
3%	19.8%	18.6%	21.8%	25.2%	27.7%	29.6%
4%	19.8%	18.9%	24.1%	27.6%	30.0%	31.6%
5%	**19.8%**	**20.3%**	**26.0%**	**29.5%**	**31.6%**	**32.9%**
6%	19.8%	21.7%	27.6%	30.8%	32.7%	33.7%
7%	19.8%	22.9%	28.8%	31.9%	33.4%	34.2%
8%	19.8%	23.9%	29.9%	32.6%	33.9%	34.5%
9%	19.8%	24.9%	30.7%	33.2%	34.2%	34.7%
10%	19.8%	25.8%	31.5%	33.6%	34.5%	34.8%

Notice how the percentage share accelerates after year 10? That's when revenue has broken through the $7.5bn boundary. In fact, with 5% inflation they get there after 8 years (around 2014), and everything above it get's charged at 35%. Oh, and we almost forgot, MTRC also has to pay HK $4.25bn up front.

As you can see from the tables, the future revenue sharing percentage, and hence the profit available to MTRC, is heavily dependent on the inflation rate. When I asked the MTRC board at the 2006 AGM what inflation assumption, if any, they had made in evaluating this deal, the CFO refused to say, other than "a range", and then he went off on an irrelevant tangent about how there would be an "independent board committee" comprised of "independent directors", all of whom, of course, are elected by the Government, which is MTRC's majority shareholder and also owns KCRC.

The original adviser to the HKSARG on the Rail Merger was N M Rothschild & Sons (Hong Kong) Ltd (**Rothschild**). They issued a report to the HKSARG on 12-Aug-03. An abridged version of this was provided to the Legislative Council's Panel on Transport on 8-Apr-04, in which Rothschild stated:

> "a full merger between KCRC and MTRCL is most likely to achieve... the greatest degree of benefit for shareholders..."

The HKSARG has in essence rejected that advice by pursuing an operating lease arrangement between the KCRC and MTRC. I note that Rothschild is no longer advising HKSARG and that Citigroup and HSBC are now named as advisers.

Future capital expenditure

Did you notice that I said "existing" KCRC assets? That's because all the burden of the future maintenance and replacement of those assets, including trains, control and signalling equipment, tunnel repairs, and so on, will fall on MTRC. All that MTRC gets is the existing assets "as is", plus the finished KSL and LMC Spur Line, and at the end of the 50-year franchise, the rights to all of it will revert to KCRC. This is, in essence, a "repair and replace" lease of assets. As the Government explained in a paper to the Legislative Council:

> "KCRC [will] retain ownership of the assets, capture the upside of KCR railway's performance under a revenue-sharing mechanism and get back a fully operational railway system at the end or upon early termination of the service concession."

Sounds great for KCRC, but what does that leave for MTRC then? In early years of the 50-year franchise, the burden of capital expenditure on KCR assets may be relatively light, as the trains are not so old, but you can be confident that the trains will either be worn out or obsolete within a couple of decades. So at the same time as revenue sharing will be increasing towards the maximum of 35%, capital expenditure will also be increasing, draining resources from MTRC. In effect, long before 2056, when the franchise expires, virtually all of the assets apart from the tunnels themselves will have been replaced using MTRC's dollar, but those replaced assets will then revert to KCRC as a "fully operational railway system" without any payment in return.

Fare autonomy

A huge selling point in MTRC's prospectus from 2000 was:

> "[MTRC] has autonomy to determine its own fares without any requirement to obtain the approval of Government or any other body."

To understand why this is so important, you have to realise that the current HK Government pursues a socialist transport policy in which all forms of domestic public transport are indirectly subsidised. Franchised buses, for example, pay only $50 per seat per year (plus $25 for the driver) in vehicle tax, and since 1992 have been exempt from fuel duty, which means they pay no incremental costs for road usage or air pollution. This subsidy alone is worth billions of dollars in revenue. As a consequence, bus fares are far lower than they would be on a "user pays" basis for the roads (including the land they occupy, road construction and maintenance) and air pollution. Hence rail fares have to be low to compete with the subsidised buses. There's also no duty on LPG, which powers most taxis and an increasing proportion of minibuses, even though LPG still creates air pollution and the vehicles still use roads.

The Government even prohibits the registration of private cars which run on LPG, because that would allow private motorists to benefit from the hidden subsidy to taxis. For the same reason, they prohibit (by high emissions standards) the registration of private diesel cars, so that the Government can subsidise goods vehicles and private buses, which pay only $1.11 per litre of ultra-low sulphur diesel compared with $6.06 per litre of unleaded petrol. So if you are jealous of motorists in Europe using fuel-efficient modern diesel-powered cars, or of Australians in their LPG-powered cars, then you are out of luck.

In the face of all this subsidised competition, the only way HK's railways can be made financially viable is to subsidise them too, mainly with property development rights, which are granted to the rail companies, which then enter into joint ventures (on secret terms) with members of the property development oligopoly to develop the sites. The land premiums for these sites are discounted on the basis that the railway station does not exist, and that allows the rail company to capture the uplift in value even though they didn't own the land around the station to start with. Most ironically, the value of housing in remoter parts of HK is supported by the low cost of getting to work in the urban areas on this subsidised transport.

Property Autonomy

I pause to note that another aspect of the proposal which removes value from MTRC shareholders is that the Government would impose a mechanism by which it can control the level of flat production by controlling the rate at which MTRC tenders new property developments. This amounts to further intervention in the commercial decisions of MTRC, which would be surrendering autonomy to make its own decisions in the best interests of all its shareholders, and no payment is offered for that surrender.

Indeed this intervention was evident in practice when the MTRC stopped tendering projects on 13-Nov-02, the same day as a Government land sales moratorium was announced. In future, the proposal would legitimise the intervention. It may well make commercial sense from time to time for MTRC to slow down or accelerate its developments, but that should be a decision for MTRC on its own, not driven by Government policy.

I find it ironic that in 2000, when MTRC was floated, the publicity campaign for the IPO was based on telling retail investors "You're the Boss". Nothing could be further from the truth, but the vote on the rail merger is the one occasion on which it will be true.

The upside of fare autonomy

A future, wiser government may see the merits of shifting towards a market-based user-pays transport policy. For example, they may introduce electronic road pricing (for all vehicles), and make buses pay for roads and air pollution by charging fuel duty on each litre of fuel they burn. They might also auction "landing slots" at urban bus stops to incentivise more efficient routing, increasing the use of interchange hubs and reducing urban congestion and pollution.

If a future Government pursued a user-pays transport policy, then road transport costs and fares would increase, and railways would be able to raise fares to a more commercial level while remaining competitive with road transport. The taxpayer would also benefit, because the Government would get higher revenues from fuel duty and new revenues from road pricing, and would be able to withdraw some or all of the property subsidy to the rail companies and sell the land directly in the open market at full value. Land (including reclamation) which would have been needed for yet more roads could instead be used for other purposes. Social security payments for those who are unable to afford the fares could be increased, but there is no reason why affluent members of society should receive subsidised public transport as they do at present.

So the potential for real increases in fares under a less socialist, more market-based, user-pays transport policy offers tremendous potential for MTRC, and that's the value of fare autonomy, but they propose to give this up, with the exception of the Airport Express railway, cross-border links to the mainland, and the cable car to the Lantau Big Buddha - so what, these are already closer to user-pays cost anyway.

In the proposed deal, future fare increases would be capped at the rate of inflation minus a productivity factor. The rate of inflation would be the average of the Composite Consumer Price Index and the Transport Wage Index. The productivity factor, which would be excluded for the first 5 years, would start at 0.1% per year, and would be reviewed every 5 years.

So what you have here is a formula which allows for no real (inflation-adjusted) increase in fares, but gives an ever higher proportion of revenue to KCRC while saddling MTRC with future capital expenditure. MTRC has pitched this to investors as a "Downside protection provided by Variable Annual Payment structure", when in fact this is an "upside-removed, downside on inflation" deal.

Government pandering

There is barely a day goes by without elected legislators from the democratic or pro-Beijing camp berating the Government for this or that high fare on buses, ferries or trains. It's an easy way to score points with the electorate, many of whom live in subsidised housing and have missed out on the benefits of Hong Kong's economic growth in recent decades, thanks in part to the way the economy is dominated by cartels.

But the fact is, we have some of the lowest fares in the world for any modern rail or bus network, subsidised or not. In London, for example, you can't go anywhere on the tube for less than a pound (HK$14.83), even though London Transport received GBP651m (HK$9.7bn) in grants in 2002/03. In HK, you can go from Chai Wan to Tsuen Wan, a 51 minute journey from the end of one line to the far end of another, for HK$11.80, or you can take a bus all the way from Central to Stanley Prison (handy for visiting the relatives) for $7.90.

The Government has attempted to buy legislative approval of the merger with a package of rail fare cuts, so that if legislators vote it down, the Government will accuse them of voting against fare cuts. For example, in a blatant PR ploy, for 1 year after the merger there would be a $2 Sunday fare for the elderly. There would also be a 2-year fare freeze. These proposed fare cuts will more than eliminate the near-term savings achieved by MTRC from synergies, including what they euphemistically call "staff synergy" (job losses) in the management layers, leaving shareholders worse off.

I urge Legislators to ignore this Government pandering and to focus on what is in the best interests of Hong Kong - a subsidised, socialist transport policy, or a more economically efficient market-based transport policy, leading to a more efficient allocation of public resources, including land and clean air?

Confidentiality or collusion?

The MoU is described as "Confidential". What is it that the Government doesn't want us to see, and why won't they publish it? I asked that at the MTRC AGM too, and got the usual puff about "commercial sensitivity". The secrecy with which the rail companies conduct their property projects, including the financial details of winning tenders, leaves an enduring suspicion of potential economic inefficiency or, at worst, collusion. There is no logic in the argument that the terms of a winning tender should be secret. Transparency would ensure a more level playing field for developers, and probably increase proceeds since it would help bidders in future tenders to make more competitive bids.

Transparency would also reduce the risk of multi-parameter bids turning an objective single-parameter tender into a subjective beauty parade. For example, if one bidder offers to let MTRC keep some retail space and a 30% profit share on the residential portion of the project, and another bidder offers a 35% profit-share but no retail space, then which bid is better? It depends on your view of future prices, and the secrecy ensures that the railway companies don't have to justify their choice. In such situations, MTRC and KCRC could just as easily be allocating the projects among the developer oligopoly based on an "it's your turn now" principle. Share it around and keep them all happy. I hope that's not the case, but without transparency, we'll never know.

Where's the profit?

Now back to the so-called merger, or more accurately, the 50-year lease.

In 2005, KCRC had earnings before interest, tax, depreciation and amortisation (EBITDA) of $2,356m, or 43.8% of corresponding revenue. This was depressed partly by the opening of West Rail, but it has never been higher than 55.1%, which it reached in 2002, and was as low as 42.9% in 1995, according to the MTRC presentation. Even if we generously assume a gradual recovery to the long-term average of 49% EBITDA, when you take off a future revenue share of about 30% for KCRC, you are looking at an EBITDA margin of only 19%, out of which you have to finance and depreciate future capital expenditure on asset replacement (this averaged 14% of KCRC revenues in the last 3 years), leaving **perhaps a low single-digit profit margin if we are lucky**. Things may look OK in 2006, but it's all downhill like a runaway train from here.

Now you might think that there is some sort of compensation for taking on a near profit-less railway, such as more property development rights. However, that is not true, because although MTRC will get some developments, they have to pay KCRC $4.91bn for the full fair market value of those rights (which KCRC received from Government for free in the past), based on a professional independent valuation. So there's no free lunch there, no compensation for taking on the railway on such poor terms.

Incidentally, KCRC never had the development rights to property on West Rail - that has been retained by the Government, so all that MTRC gets on West Rail is a low-margin agency agreement for managing those projects, the details of which have not been disclosed.

Conclusion

Unless the proposed deal is revised to retain fare autonomy and to reduce KCRC's revenue share, I intend to recommend independent shareholders to vote against the deal when it is put to the vote some time in the next year. Few rational investors would be in favour of a scheme which caps revenues, links the downside on margins to inflation, and saddles MTRC with all of the future capital expenditure but none of the ownership of KCRC rail assets. It would have been far more sensible to negotiate a full corporate merger of the two entities, preserve the fare autonomy, and sell-down the Government shareholding to reduce its interference in the transport sector.

The Government's subsidised transport policy leads to economic inefficiency and contradicts Hong Kong's free-market philosophy. It would be in the public interest to move towards a market-based approach, fully recovering the cost of roads and air pollution and the value of land sold to the railways, and use some of the billions in incremental government revenues to increase social welfare payments to those who cannot afford essential transport. The higher transport-related revenues from fuel duty and road pricing would also be a stable source of Government revenues and would be consistent with a neutral fiscal policy which does not distort decisions by economic participants.

The Government and Legislators should think hard about whether to pursue a market-distorting socialist transport agenda, with heavily subsidised fares for all, or whether to pursue a more market-based solution. If "socialism with Hong Kong characteristics" is the preferred route, then the Government should buy out the minorities in MTRC, run both railways at inflation-capped uncommercial fares and have the intellectual honesty to admit that this is not a market-based system. It would be totally contrary to Hong Kong's supposedly free-market principles, but that is Government's choice to make. However, if they pursue the deal on the current terms, then MTRC independent shareholders will make that choice for them by voting it down.

I will be pleased to answer any questions you may have on this submission.

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