Speaking Points of Mr. Lincoln Leong, Finance Director of MTR Corporation, at the Rail Merger Bills Committee on 12 December 2006

Thank you Madam Chairman. Good morning honourable Members.

There is one issue which I would like to highlight from Government's Paper namely

— How property development profits are incorporated in MTR's fares. Government's paper has, I believe, well addressed the other issues raised by Honorable Members, and I would not waste members time to repeat those answers.

How Property Profits are incorporated in MTR fares

- The explanation of how Property Profits are incorporated in MTR fares, is set out in Government's Paper. I would stress that MTR's practice with regard to initial fare setting, and annual fare adjustment has not changed over the years and has been consistently applied.

- It is important to remember that MTR has used the 'rail and property' model for the construction of rail lines. Hence property development rights, from which we derive property development profits, are granted to us to bridge the so called 'funding gap' when MTR is paying for the construction of a new rail system.

- To provide a better understanding of the interaction of property development profits and fares, it is important to differentiate between the two separate stages of fare setting: a) the initial fare setting process and b) on-going (annual) fare adjustments.

- The initial fare setting process takes into account property development profits whereas, for MTR, the on-going annual fare adjustments do not take annual property development profits into account.

- I would now like to refer to the chart, Exhibit 1, on P.3 of Government's paper CB(1)442/06-07(01).

- First and foremost in any viable sustainable business, the cash profits over time must cover the following:- the initial capital costs (in our case the building of the system), asset replacement and maintenance costs, as well as a commercial return to our shareholders and lenders.

- In both the top and bottom chart of Exhibit 1, the initial capital costs, asset replacement as well as commercial return are illustrated as the bar on the far Right Hand Side. I will refer to this as the "Capital Cost and Commercial Return".

- Hence to be sustainable, the cash profits, illustrated in both the top and bottom charts of Exhibit 1 by the four other bars from the left, need to equal the Capital Costs and Commercial Return - the far Right Hand Side Bar.

- There are a number of ways of making the cash profits equal to the Capital Cost and Commercial Return.

- One way is the Rail and Property model. Under this method, Property Development Profits bridge the 'funding gap' by contributing to total cash profits, hence allowing for the very reasonable rail fares available in Hong Kong - this is illustrated in the top chart of Exhibit 1 with property development profits being the Dark Shading.

- If there is no property development profits, or any other contributions to bridge the 'funding gap', then to allow for cash profits to equal Capital Cost and Commercial Return, the 'net cash income from railway operations' must be much higher. The only way to achieve this is by significantly increasing rail fares as illustrated in the bottom chart of Exhibit 1.

- Hence with the Rail and Property model, MTR fares today already 'incorporate property development profits'. Without such property development profits or any other contribution to bridge the funding gap, fares would be significantly higher than today: as illustrated in the bottom chart of Exhibit 1.

- Given that Property Development Profits are already incorporated into the initial fare setting, for MTR the on-going annual fare adjustments do NOT, I stress, do NOT take into account again, annual property development profits. It would be "double-counting" if the on-going annual adjustment were to also take property development profits into account. What MTR has taken into account in previous annual fare adjustments are general economic conditions, market competition and value for money (ascertained through customer surveys).

- I would re-iterate that MTR fares are already very reasonable by any comparison.

- By international comparison, Honourable Members will recall the deputation by Professor Tony Ridley of Imperial College London who said, and I quote,

  > "MTR fares measured on a comparable basis against other metros in the world, are moderately priced. Following three further years of inflation in Hong Kong to 2008, in combination with the agreed reduction in fare in agreement with the terms of the merger, by 2008 MTR fares are expected to be even lower by international standards. This is despite the fact that MTR requires no operational subsidy or financial support from government." [Quote from Ridley submission - LC Paper No. CB(1)2266/05-06(07)]

- And compared with other public transport in Hong Kong,

  - MTR consistently provides value-for-money service as shown by surveys. For instance in surveys since 2002 of value for money amongst Hong Kong public transport operators, MTR has consistently ranked amongst the top 3 together with the Star Ferry and Tram. In the latest survey done in June 2006, we were ranked first in value for money.

- This reasonable fare is combined with a standard of service which Professor Ridley says has 'one of the highest levels of reliability and service quality, with high levels of efficiency and productivity at low unit cost by international standards'.

Thank you Madam Chairman.

Exhibit 1

EXPLAINING INITIAL FARE SETTING WITH PROPERTY PROFITS