立法會
Legislative Council

LC Paper No. CB(1)1969/05-06
(These minutes have been seen by the Administration)

Ref : CB1/PL/TP/1

Panel on Transport and
Panel on Financial Affairs

Minutes of joint meeting held on
Tuesday, 23 May 2006, at 2:30 pm
in the Chamber of the Legislative Council Building

Members present : Members of the Panel on Transport

Hon LAU Kong-wah, JP (Chairman)
Hon Andrew CHENG Kar-foo (Deputy Chairman)
Hon Mrs Selina CHOW LIANG Shuk-yee, GBS, JP
Hon LAU Chin-shek, JP
Hon Miriam LAU Kin-yee, GBS, JP
* Hon Abraham SHEK Lai-him, JP
Hon LI Fung-ying, BBS, JP
Hon Tommy CHEUNG Yu-yan, JP
Hon Albert CHAN Wai-yip
Hon WONG Kwok-hing, MH
Hon LEE Wing-tat
* Hon Jeffrey LAM Kin-fung, SBS, JP
Hon CHEUNG Hok-ming, SBS, JP
* Hon Albert Jinghan CHENG

Members of the Panel on Financial Affairs

Hon Ronny TONG Ka-wah, SC (Deputy Chairman)
Hon James TIEN Pei-chun, GBS, JP
Hon James TO Kun-sun
Hon CHAN Kam-lam, SBS, JP
Hon Andrew LEUNG Kwan-yuen, SBS, JP
Hon CHIM Pui-chung
Hon TAM Heung-man

(*also a member of the Panel on Financial Affairs)

Members attending	:	Hon Albert HO Chun-yan Hon KWONG Chi-kin
Members absent	:	Members of the Panel on Transport * Ir Dr Hon Raymond HO Chung-tai, S.B.St.J., JP Hon TAM Yiu-chung, GBS, JP Hon LEUNG Kwok-hung Members of the Panel on Financial Affairs Hon Bernard CHAN, JP (Chairman) Hon LEE Cheuk-yan Dr Hon David LI Kwok-po, GBS, JP Hon SIN Chung-kai, JP Hon Emily LAU Wai-hing, JP Hon WONG Ting-kwong, BBS (*also a member of the Panel on Financial Affairs)
Public Officers attending	:	Dr Sarah LIAO Secretary for the Environment, Transport and Works Mr Frederick MA Secretary for Financial Services and the Treasury Mr Patrick HO Deputy Secretary for the Environment, Transport and Works Mr Martin GLASS Deputy Secretary for Financial Services and the Treasury
Attendance by invitation	:	MTR Corporation Mr C K CHOW Chief Executive Officer Mr Lincoln LEONG Finance Director Mr Thomas HO Property Director

Mrs Miranda LEUNG
General Manager – Corporate Relations

Kowloon-Canton Railway Corporation

Ir James BLAKE
Chief Executive Officer

Mr Daniel LAM
Director – Property

Mr Lawrence LI
Director – Finance

Mrs Grace LAM
General Manager – Corporate Affairs

Citigroup Global Markets Asia Limited

Mr Frank SLEVIN
Managing Director and Chief Operating Officer,
Asia Pacific Investment Banking

Clerk in attendance : Mr Andy LAU
Chief Council Secretary (1)2

Staff in attendance : Ms Sarah YUEN
Senior Council Secretary (1)6

Miss Winnie CHENG
Legislative Assistant (1)5

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I Election of Chairman

Mr LAU Kong-wah was elected Chairman of the joint meeting.

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II Merger of MTR and Kowloon-Canton Railway Systems —— Financial and property packages

(LC Paper No. CB(1)1291/05-06(01) - Information paper entitled" Merger of MTR and Kowloon-Canton Railway Systems - Proposed Way Forward" provided by the Administration for the joint Panel meeting on 12 April 2006

LC Paper No. CB(1)1541/05-06(01) - Administration's response to members' questions on the rail merger proposal raised at the joint Panel meeting on 12 April 2006)

Proposed transaction structure

2. Mr WONG Kwok-hing enquired about the rationale for adopting the proposed service concession arrangement and whether the proposed deal structure was in the best interest of the general public. The Secretary for Financial Services and the Treasury (SFST) replied that in considering the deal structure, Government had examined alternative options other than the service concession approach in the merger discussions, such as an outright sale, but considered that they were less appropriate. At present, the total assets of Kowloon-Canton Railway Corporation (KCRC) amounted to some $90 billion. In 2005, the return on equity for KCRC was only 1%. In any outright sale, it was very likely that the potential buyer would emphasize any under-performance by KCRC while downplaying the long-term potential of the system. In order to avoid disposal of KCRC’s assets at a severely diminished valuation, Government had sought a structural solution under which KCRC could retain ownership of the assets, capture the upside of KCR railway’s performance under a revenue-sharing mechanism and could get back a fully operational railway system at the end or upon early termination of the service concession.

3. Mr Ronny TONG opined that there were other alternatives for taking forward the merger proposal other than the proposed selling of KCRC’s assets at a severely diminished value. He also remarked that at the moment, many parts of the KCR system were newly commissioned or under construction, and these parts would see an increase in patronage and revenue some time after they were commissioned and in operation. As such, he queried whether it was justified to go ahead with the rail merger in its present form. SFST noted Mr TONG’s view and remarked that this explained why Government proposed to effect the rail merger by means of a service concession agreement under which the Government was not disposing of the assets of the KCR system.

Fixed annual payments

4. Regarding the fixed annual payments of $750 million for the duration of the service concession, Mr Andrew CHENG sought the Administration’s explanation of the

basis used in arriving at such payment amount. Mr Frank SLEVIN, Managing Director and Chief Operating Officer, Asia Pacific Investment Banking, Citigroup referred members to paragraphs 24 to 27 of LC Paper No. CB(1) 1291/05-06(01), which set out the basis of the financial terms agreed with MTR Corporation Limited (MTRCL). In considering the terms and structure of the merger deal, the prime consideration was an evaluation of the cash flow generated from the KCR system, together with the operating costs and commitments on maintenance, improvements and the renewal of the system for a period of 50 years. Other factors that had been considered included the risks associated with fluctuations in patronage in respect of the KCR system, future debt obligations of KCRC and the affordability of the terms to MTRCL while striking an appropriate balance between the interests of all of the parties concerned. The Government would share in the potential out-performance of KCR system above a revenue threshold in the form of an "earn-out" structure with variable annual payments being made by the post-merger corporation (MergeCo) based on revenues attained by operation of the KCR system. This would ensure that Government would capture the upside performance of the KCR system.

Concession period

5. Mr Andrew CHENG queried the rationale for setting the term of the service concession agreement at 50 years. He opined that in line with the franchise period for other "Build-Operate-Transfer" tunnels, the duration of the agreement should be shortened to 30 years, with an option for extension subject to an interim review. SFST said that railway operations involved long-term investment by railway corporations. If the duration of the service concession agreement was shortened, MergeCo would not have sufficient time for its investment to pay off. Regarding the proposal for an interim review, SFST remarked that this would create uncertainties to investors. Having considered all the relevant factors, the Administration was of the view that the service concession should have a term of 50 years.

Valuation

6. Mr WONG Kwok-hing was concerned that the proposed property package was intended to gain the support of shareholders of MTRCL. He was worried that Government would dispose KCRC's assets at a severely diminished valuation at the expense of Hong Kong people who owned the assets of KCRC. SFST said that the merger package was a fair and balanced package. Given that the property package was an integral part of the whole merger deal, after discussion with MTRCL and taking into account the advice of the independent valuer, namely Savills, the Administration considered that MTRCL's latest offer of $7.79 billion to purchase the properties and property development rights as part of the merger package was acceptable. He further said that valuation services were widely used by listed companies in all the key segments of real estate and business deals. With the expert knowledge and experience of independent valuers, they were able to advise their clients for all business valuations. SFST also provided the following valuation of the property package –

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The Property Package	**Government valuation (million)**
Property development rights at 8 sites	$4,910
Investment properties at 8 sites	$2,840
Management businesses and rights relating to properties at 33 sites	$40

7. Mr WONG Kwok-hing remarked that in order to ensure that the merger package was a reasonable and equitable deal, and did not involve any possible collusion between Government and businesses as well as transfer of benefits, there was a need for the Administration to provide detailed information about the property package including valuation of individual sites, rental/revenue derived from the investment properties and management businesses, etc. In the absence of such information, members could not judge whether Government had disposed KCRC's assets at a severely diminished value.

8. SFST reiterated that the property package was an integral part of the whole merger deal and the merger package was a fair and balanced package. KCRC would receive a payment of $7.79 billion for the acquisition of property and other related commercial interests. Of which, MTRCL would pay $4.91 billion for the rights over the eight property development sites. As the sites were expected to be developed over a number of years, the assessed development profits were discounted to give the present value. For future property developments, MergeCo was still required to pay the full market value land premium to the Government. SFST emphasized that the property package was an integral part of the whole deal. It would not be appropriate for members to focus simply on the valuation of individual sites.

9. Mr Ronny TONG remarked that despite repeated calls from members, the Administration was still unwilling to release detailed information on the valuation of the proposed property package. As Members were elected to monitor the work of the Government, they could not discharge their duties if Government refused to provide the necessary information to the Panels. He also remarked that instead of the proposed transaction structure, Government could put KCRC's properties up for auction or tender and use the proceeds from the property package for subsidizing railway operations and fare reductions. This could avoid disposal of KCRC's assets at a severely diminished valuation. He also enquired about the merits of the proposed rail merger and how the proposed sale of KCRC's properties could bring benefits to the general public. SFST remarked that as some of the railway property developments had yet to be tendered, it would place MergeCo in a disadvantaged position in future tendering exercise if valuation details of individual sites which were essentially commercial sensitive information were disclosed to the public. He also said that as the property package was an integral part of the whole merger deal, after discussion with MTRCL and taking into account the advice of the independent valuer, the Administration considered that the property package was a fair deal. Mr Ronny TONG was unconvinced of the

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Administration's reply. He requested the Administration to provide detailed information on the valuation of individual properties.

10. The Secretary for the Environment, Transport and Works (SETW) added that with the rail-and-property model, Hong Kong had been able to benefit from a world-class metro system. Compared with the traditional approach of selling Government land by way of public auction or tender, the overall benefits generated by granting property development rights to MTRCL were much more significant. Mr C K CHOW, Chief Executive Officer, MTR Corporation Limited (CEO/MTRCL) added that under the rail-and-property model, Government did not need to inject cash for implementing railway projects but rather, in the past 30 years, had gained over $100 billion. Government had received land premium amounting to more than $70 billion when the concerned sites were developed. As MTRCL was a listed company based on the rail–and-property model, Government had a realizable value equal to 76% of its market capital after already realizing $10 billion from the Initial Public Offering (IPO) proceeds, plus cash dividends. All these represented the optimal use of public resources and the continuation of the rail-and-property model was in the best interest of the general public.

11. Miss TAM Heung-man was disappointed that the Administration was unwilling to disclose information to enable Members to monitor the work of the Government. Given that disposal of KCRC's assets involved public monies, Members would need to ascertain whether the deal was fair and represented the best interest of the general public. In the absence of the necessary information, Members and the general public would be kept in the dark. SFST replied that the professional property valuation consultant had adopted a methodology for property valuation which was commonly accepted in the market. He drew members' attention that other than the payment of $7.79 billion for the acquisition of property and other related commercial interests, KCRC would also obtain an upfront payment of $4.25 billion, fixed annual payment of $750 million and variable annual payment based on actual revenue generated from the KCR systems.

12. Miss TAM Heung-man was worried about the disposal of KCRC's assets at a severely diminished valuation. She enquired whether the Administration had explored other alternatives such as reducing the annual payments for the service concession rather than selling KCRC's assets to MTRCL. She also queried why the property package must be an integral part of the whole merger deal. In her opinion, the property package was merely intended to gratify small investors in return for their support of the merger deal. SFST replied that the proposed financial terms for the rail merger were a fair and balanced deal and the merger package would bring overall benefits to the community as a whole. There was no question of putting forward the property package to gratify anyone. The transaction terms were reached after thorough discussions, taking into account the advice of the independent valuer.

13. Mr Albert HO remarked that Government had all along been saying that it was not conversant with business operations, and hence it was necessary to set up various

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corporate bodies to operate the related businesses in accordance with commercial principles. However, in the present rail merger exercise, the Government had been playing an active role in the discussions. It also appealed to Members for their support for the proposed terms and structure of the merger deal which might not be in the best interest of the general public. On property developments above or adjacent to railway stations, Mr HO maintained the view that property development rights should not be granted to MTRCL direct without auction or tender. He also queried why there was a need to grant MTRCL the right to purchase KCRC's management business. SFST replied that the property package was an integral part of the whole merger deal. He could not accept the view that the package deal was to the disadvantage of the Government. In considering the merger deal structure and financial terms, the Government had sought the advice of the independent valuer and considered that MTRCL's latest offer to purchase the properties as part of the merger package was acceptable. CEO/MTRCL added that as the property package was an integral part of the whole merger deal, any modification to the agreed financial terms would necessitate a re-negotiation of the total package among the parties concerned. He remarked that as stipulated in the IPO documents, the Corporation was a company that would conduct businesses in transportation and property. Property developments supported the construction of railway projects as well as contributing to rail patronage from the immediate catchment areas created by such property developments. The rail–and-property model allowed the Corporation to capture the enhanced land value along railway routes and to invest it in the construction of the railways. This model created more value for Government than the traditional land sale approach. The rail-and-property model had been creating tremendous value for the people of Hong Kong. Government, being the majority shareholder of MTRCL, would also benefit from the merger transaction if it was well received by the capital market.

14. Mr Andrew CHENG remarked that as railway operations had not been profitable, requiring cross-subsidization from profits on property developments, he was worried that if future fare adjustments would not take into account profits derived from property developments, the rate of increase would be quite substantial. Worse still, Government had refused to set up a fare stabilization fund to moderate future fare increases. Mr CHENG also said that he could not see why the Administration could not release information on Government's valuation of individual property sites to the Panels. He pointed out that he would invite members to consider invoking the powers under the Legislative Council (Powers and Privileges) Ordinance (Cap. 382) to order the Administration to produce such information if necessary. In the absence of the necessary information, it would be difficult for members to judge whether Government had disposed KCRC's assets at a severely diminished value. He also enquired about the details of the synergies of selling KCRC's investment properties, property management business and property development rights to MTRCL and requested the Administration to provide further information in this respect.

15. SFST replied that the Administration was prepared to disclose the key information relevant to Government's valuation such as site area, plot ratio, gross floor

area, etc. However, with regard to valuation details of individual sites, the Administration had to discuss further with MTRCL as some of the information might contain commercial sensitive data. He also reiterated that there was no question of disposal of KCRC's assets at a severely diminished value. Under the service concession agreement, a right was granted to MTRCL to access and use certain KCRC assets to operate the existing and new KCR railway lines under construction. Upon expiry or termination of the service concession, MergeCo was obliged to deliver back to KCRC a KCR system that met the prevailing operating standards.

16. Regarding the valuation on the property and related commercial interests included in the property package, Mr LEE Wing-tat disagreed that disclosure of the valuation details would have a bearing on future tender prices. Indeed, it was a common practice for the Administration to include a project estimate in all funding proposals submitted to the Finance Committee. He urged the Administration to provide detailed information about the Government's valuation of the property package.

17. Mr Albert HO queried the need for including the purchase of KCRC's property management business by MTRCL as an integral part of the deal. Without putting the businesses up for auction or tender, it might invite criticism for selling the businesses at a severely diminished value, which was a kind of transfer of benefits and would not be in the best interest of the general public. He requested the Administration to provide further information to allay members' concerns.

18. Mr Abraham SHEK declared interest as a Managing Board member of KCRC. Referring to the media report that the valuation of the property development rights over the eight property development sites was substantially below market price, Mr SHEK remarked that the payment of $4.91 billion was for the rights over these sites, being the share of the property development profits which MergeCo might realize from joint development of these eight sites with its property developer partners. It would be misleading if such payment was used to calculate the average selling price of the property developments. For future property developments, MergeCo was still required to pay the full market value land premium to the Government. Further, the market risks of these property developments which would take a number of years to complete would rest with MTRCL.

19. Mr Albert HO enquired about the level of details to be disclosed to small investors for their consideration of the merger deal, particularly those related to the valuation of the property package. SFST said that as a listing requirement, MTRCL had made a public announcement that it had entered into a Confidential Memorandum of Understanding with Government in relation to the rail merger with KCRC. Whilst the announcement contained essential information about the proposed financial terms and structure of the deal, it did not cover how value of individual property sites was calculated. He confirmed that the information provided by MTRCL to its shareholders was more or less the same as those provided to Members. In response to Mr Ronny TONG's further question, CEO/MTRCL said that in accordance with the Listing Rules,

MTRCL would establish an independent board committee to advise shareholders as to whether the terms of the rail merger were fair and reasonable and whether the rail merger was in the interests of the Company and its shareholders as a whole, taking into account the recommendations of an independent financial adviser, which would be appointed by this independent board committee in due course.

Payments relating to enabling works

20. Noting that MTRCL would reimburse KCRC for the costs of enabling works already paid for by the latter in relation to the development properties to be sold to MTRCL, Mr Ronny TONG enquired about the details of the estimate. The Deputy Secretary for Financial Services and the Treasury replied that in relation to the eight sites whose property development rights would be purchased by MergeCo, amounts spent by KCRC in funding the enabling works for property development above railway stations should be recovered from the developers of those sites or reimbursed by MergeCo. The payments for the costs of these works not yet received by KCRC were currently valued at $2.31 billion.

Railway property development control mechanism

21. Referring to the proposed property development control mechanism whereby Government could exercise control on the level of flat production arising from the tender programme for railway property developments, Mr LEE queried the rationale for putting in place such a mechanism. He remarked that the restriction on the property development projects of MergeCo might give rise to public concern about the possible collusion between the Government and property developers, and transfer of benefits. The restriction would also unduly affect the income of MergeCo which might lead to fare increase. SFST replied that he would relay Mr LEE’s concern to the Secretary for Housing, Planning and Lands for further consideration. CEO/MTRCL added that MTRCL would take into account the demand of the market before inviting tenders for property development. The proposed property development control mechanism was a means to formalizing the existing arrangement.

22. Mr WONG Kwok-hing also enquired about the operation of the said proposed property development control mechanism. The Deputy Secretary for the Environment, Transport and Works explained that Government and MergeCo would conduct an annual exercise to discuss and draw up a three-year rolling programme on the level of flat production arising from tenders for railway property developments by MergeCo for the three ensuing years. The agreed level for the first year of each of such three-year rolling programmes would be binding on MergeCo.

23. Mr Albert HO remarked that the poor financial performance of KCRC was partly attributable to Government’s housing policy under which the property developments along the West Rail corridor were deferred. SETW replied that KCRC, being a statutory corporation established primarily for the operation of the KCR system, might not be able

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to leverage its competitive advantage in property development by obtaining development sites in conjunction with railway development.

24. Referring to a previous property transaction whereby the property developer was alleged to have disseminated misleading information to the market in order to influence the sale of the residential project, Mr LEE Wing-tat remarked that MergeCo should put in place a mechanism to ensure that potential buyers could obtain adequate and accurate information when considering purchase of uncompleted residential units launched by MergeCo or its business partners. Mr Thomas HO, Property Director of MTRCL, said that the developer had clarified that the buyer who purchased the flat at the price of over $30,000 per square foot had not purchased any other flats in the same residential development. MergeCo would ensure that developers would comply with the guidelines of the Government on the sale of uncompleted residential units.

Railway performance

25. Mr LEE Wing-tat also remarked that as MergeCo would be responsible for the operation, maintenance and improvement of the KCR system, including the replacement of the concession assets, during the concession period, there would be a great incentive for MergeCo to cut maintenance budget and other service improvement plans so as to maximize its profit at the expense of the travelling public. He enquired about the controlling mechanism for ensuring that MergeCo would be able to provide a safe, reliable and quality railway service at all times.

26. SETW replied that at present, MTRCL was already a listed company and it had a very good track record in maintaining a safe and efficient service at all times in accordance with the established regulatory regime by the Government. Amongst other things, MTRCL was required to maintain a safety management system to minimize safety risks. Government would also closely monitor the performance and safety of MTRCL in accordance with a set of parameters. She envisaged that there would be no major difference after the rail merger in terms of safety requirements and the regulation of service performance. MTRCL, being a listed company, also would not want to see the deterioration of its service which would seriously affect its valuation in the capital market.

Fare-related issues

27. Mr Andrew CHENG relayed the concern of Mr Albert CHAN about the possible use of financial techniques by MergeCo to manipulate the level of fare increase which might adversely affect the interest of the travelling public. CEO/MTRCL said that as a listed company, the accounts of the Corporation had to be prepared in accordance with the Listing Rules and the Hong Kong Companies Ordinance. As such, there was no question of misrepresentation of the accounts. Further, future fare adjustments would be linked to changes in the Government Composite Consumer Prices Index and changes in the Nominal Wage Index (Transport Sector) published by the Census & Statistics

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Department, and would have no direct relationship with the profits of the Corporation.

28. Mr Andrew CHENG remarked that despite the earning of huge profits, MTRCL had been reluctant to reduce its fares to benefit the general public. In order to balance the interests of passengers and shareholders of MergeCo, he called on the Administration to set up a fare stabilization fund and put aside a certain proportion of the proceeds from property developments to the fund to moderate future fare increases. SFST said that there was no question of Government disposing of KCRC's assets at a severely diminished value as under the service concession agreement, MTRCL was only granted a right to access and use certain KCRC's assets to operate the existing and new KCR railway lines. KCRC would also receive a variable annual payment for the service concession calculated as a percentage of revenue generated from the KCR System for each financial year. SETW added that there was no need to set up a fare stabilization fund. Under the proposed formulaic approach, future fare adjustments would be determined based on published indices which were objective and verifiable.

III Any other business

29. There being no other business, the meeting ended at 4:25 pm.

Council Business Division 1
Legislative Council Secretariat
12 July 2006