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22 May 2006

Dear Mr Lau,

Merger of MTR and Kowloon-Canton Railway (KCR) Systems
- Proposed Way Forward

At the joint meeting of the Panel on Transport and the Panel on Financial Affairs on 12 April 2006, Members requested the Administration to provide certain supplementary information. The requisite information is set out as follows:

1) Details on the evaluation of various options for the structure and the financial terms for the proposed merger of the MTR and Kowloon Canton Railway systems

The structure and financial terms of the current merger proposal were drawn up based on the proposed Service Concession approach. The Government has considered alternative options other than the Service Concession approach in the merger discussions, such as an outright sale, but has taken a view that they are less appropriate for the current exercise.

2) **Details on the basis of the valuation for the proposed acquisition of property and other related commercial interests**

The Government appointed a professional property valuer to conduct valuation on the property and related commercial interests included in the property package. The valuation was based on factual information and forecasts provided by Kowloon-Canton Railway Corporation (KCRC) (such as location, site area and gross floor area, revenue, cost and project implementation programme), and our property valuer has adopted a commonly accepted property valuation methodology in line with market practice. Our property valuer considers the price of the property package fair and reasonable.

3) **Consider adopting a revenue-sharing mechanism for the property package of the rail merger proposal**

The property package forms part of the merger proposal. The proposal as a result of the merger discussion is for the property package to be sold to MTR Corporation Limited (MTRCL) on market terms, and our property valuer has confirmed that the price of the property package is fair and reasonable. We do not see any strong justification to adopt a revenue-sharing mechanism in this regard, where Government would retain a considerable amount of property market risk.

4) **Details on the remaining assets held by the Kowloon-Canton Railway Corporation (KCRC) after the rail merger and their residual values**

Under the service concession approach, assets which are necessary for the operation of the KCR system would be provided to the post-merger corporation. In addition, the items included in the property package would have been sold as part of the merger package. All other assets of KCRC which do not form part of the service concession proposal or the property package, such as cash, receivables and shareholding in Octopus, would remain with KCRC. Valuation was conducted only to establish the terms of the service concession and the property package for the purpose of the rail merger. We did not conduct any valuation on the other assets which are to remain with KCRC, which falls outside the scope of the current exercise.

5) **Details on whether the existing fare structure of KCRC would be revised so as to bring it in line with that of the MTR Corporation after the rail merger**

On the first day of the rail merger, the railway fares including those for the KCR services will be reduced in accordance with the proposed fare reduction package. Thereafter, the railway fares will be adjusted in accordance with the proposed fare adjustment mechanism, on the basis of the reduced fare level.

6) **Consider revising the fare reduction package with a view to further expanding the scope of fare reduction for both long-haul and short-haul passengers. Consideration should also be given to reducing the fares of Light Rail Transit, Airport Express and East Rail service to / from Lo Wu**

Under the proposed fare reduction package, the rail fares will be reduced from day one of the merger, benefiting 2.8 million daily passenger trips. The fares for long distance journeys will be reduced by a minimum of 10% and there will be different reduction rates for medium and short distance journeys. As a result, there will be 340,000 daily passenger trips enjoying a fare reduction of at lease 10% per trip. Further, 1.16 million daily passenger trips will enjoy a minimum of 5% reduction per trip.

The Light Rail system has been in deficit requiring cross-subsidisation from KCRC's other operations. There is little scope for fare reduction which will affect the sustainability of the system. It is noted that nearly one-third of its passengers are already enjoying free Light Rail service for interchange with West Rail, and frequent users can benefit from the "Light Rail Frequent User Bonus Scheme" which provides fare concession equivalent to about 10% discount.

The objective of the fare reduction package is to benefit local commuters in domestic travels. The main service target of the Lo Wu service is different from the domestic railway services. There are historical reasons to maintain a different fare structure of the Lo Wu service which helps maintain a relatively low fare levels for the East Rail service between Sheung Shui and Tsim Sha Tsui East. The reduction of Lo Wu fares will have a negative impact on the East Rail domestic fares which will affect over 660,000 daily commuters and will also adversely affect the financial position of the post-merger corporation.

As regards the Airport Express Line (AEL), the service is not used by commuters as a form of daily travel. Airport workers who are frequent users of AEL are already provided with substantial discount.

The present proposal is the result of detailed discussion and negotiation and we believe it is a fair and balanced proposal.

I should be grateful if you would circulate this letter to the Members of the Panel on Transport and the Panel on Financial Affairs.

Yours sincerely,

(Miss Ida LEE)
for Secretary for the Environment,
Transport and Works