
INFORMATION NOTE

Major Changes Proposed in the Draft Integrated Operating Agreement between the MTR Corporation Limited and the Government

1. Background

1.1 At the meeting of the Bills Committee on Rail Merger Bill (Bills Committee) held on 19 December 2006, Members discussed a draft integrated Operating Agreement (OA) between the MTR Corporation Limited (MTRCL) and the Government.¹ At the meeting, Members requested the Research and Library Services Division (RLSD) to compare the existing OA with the draft integrated OA, and identify whether there are any major changes proposed to be made to the existing OA.

1.2 RLSD asked the Government to provide the existing OA for comparison purpose. The Government replied that the draft of OA dated 4 January 2000² had already included all the major provisions of the existing OA. Hence, RLSD has used this draft to do the comparison.

1.3 This note focuses on the following seven areas of concerns raised by Members:

- (a) land issues;
- (b) new projects;
- (c) fare regulation;
- (d) performance requirements;
- (e) customer service pledges;
- (f) safety management; and
- (g) disclosure of information.

¹ Upon the implementation of the proposed merger between the Mass Transit Railway (MTR) and Kowloon-Canton Railway (KCR) systems, the existing OA between MTRCL and the Government will be expanded into an integrated OA to cover the regulation of the operation of both the MTR and the KCR railway systems.

² See Transport Bureau (2000).

Table — Major changes proposed in the draft integrated Operating Agreement

| | Draft of the existing Operating Agreement | Draft integrated Operating Agreement |
|-------------|---|--|
| Land issues | <p>This section contains the framework for the grant of land required for railway projects by the Government to the Corporation³. The framework is described in a paper entitled <i>Property Development Rights</i> which the Bills Committee on Mass Transit Railway Bill considered on 18 November 1999.⁴</p> <p>The policy on granting property development rights as described in the paper entitled <i>Property Development Rights</i> is summarized as follows:</p> <p>For planning, safety and technical reasons, the Government considers it generally necessary to make property development, where appropriate, above railway stations and depots, and on land adjacent to the railway, an integral part of the railway development. MTRC⁵ [Mass Transit Railway Corporation] has been designing and constructing above station property for 25 years. The current arrangement presents the most effective use of resources.</p> <p>With the Corporation being held responsible for the entire station site, the above-station or depot development can be most optimally planned and utilized.</p> <p>The integration of property and station developments also ensures that safety and operational aspects of the railway are safeguarded. With one organization managing the development and the railway, responsibilities are clearly defined and any incidents at the property development having an effect on the railway can be properly managed.</p> <p>In conclusion, the existing policy of granting property development rights, where appropriate, on top of stations and depots, and on land adjacent to the railway will continue. The current policy of charging MTRC the full market value of the land granted for such property developments will remain unchanged.</p> <p>Further details of the OA arrangements in relation to land for property development can be found in the <i>Prospectus for the MTR Privatisation Share Offer</i>⁶ (<i>Prospectus</i>).</p> | <p>This section stipulates that the Government and MergeCo⁷ shall agree the detailed terms upon which the land required for a new railway project will be provided to MergeCo and that the land premium shall be assessed in accordance with the Government's land policy at the relevant time.</p> |

³ In this information note, the Corporation refers to MTRCL.

⁴ See Transport Bureau (1999c).

⁵ Before privatization, MTRCL was known as MTRC.

⁶ The *Prospectus* states that:

Under OA, the Government has agreed that for any new railway project to be implemented by the Company [MTRCL], the Government and the Company [MTRCL] shall agree the detailed terms upon which the land required for the construction and operation of the relevant railway project will be provided to the Company [MTRCL] at a premium in accordance with the Government's land policy at the relevant time and the Government and the Company [MTRCL] shall agree the detailed terms relating to the scope of its property development rights, if any, and the way in which such property development rights should be granted to the Company [MTRCL].

The Government has acknowledged that property development by the Company [MTRCL] has been, and is expected to continue to be, important for the commercial viability of new railway projects as well as for operational and technical reasons.

The Government has also agreed that, for so long as its current land policy is maintained:

- *the amount of land premium payable by the Company [MTRCL] will be assessed on a "full market value" basis, ignoring the presence of the railway for the first land grants made by the Government to the Company [MTRCL] for property development rights in relation to each new railway project granted to the Company [MTRCL] and, if applicable, for the first premium amount payable for property development rights in relation to each development phase of such a new railway project (in each case, other than for depot sites);*
- *the amount of land premium payable by the Company [MTRCL] for railway depot use at depot sites will be assessed on an "industrial use" basis with a minimum plot ratio of one; and*
- *the amount of land premium payable by the Company [MTRCL] for the sites of running lines and stations will be assessed at a nominal premium in accordance with current policy.*

See MTR Corporation (2000), p. 107.

⁷ MergeCo refers to the post-merger corporation of MTRCL and KCRC.

Table — Major changes proposed in the draft integrated Operating Agreement (cont'd)

| | Draft of the existing Operating Agreement | Draft integrated Operating Agreement |
|--------------|---|---|
| New projects | <p>This section contains the following objectives:</p> <p>(a) annual publication by the Corporation of statement of its own anticipated future network capacity requirements;</p> <p>(b) building new lines only on prudent commercial principles⁸;</p> <p>(c) ensuring a level playing field and equal treatment with other potential competitors in the award of new railway projects and extensions; and</p> <p>(d) providing a clear framework for new projects.</p> | <p>This section contains a framework for the construction and operation of new projects by MergeCo relating to:</p> <p>(a) the KCRC [Kowloon-Canton Railway Corporation] Railway;</p> <p>(b) the MTRC Railway; and</p> <p>(c) railways that are neither part of the KCRC Railway nor the MTRC Railway.</p> <p>The framework is described in Annex A [of the paper entitled <i>Integrated Operating Agreement</i>⁹].</p> <p><u>New projects</u></p> <p><i>Natural extension of MTRC Railway (New MTR Project)</i></p> <p>The existing arrangements contained in OA would be preserved. The Government and MergeCo would discuss the financial arrangement for the New MTR Project on the basis of the ownership approach (under which the operator would fund, construct and operate the New MTR Project).</p> <p>If an agreement on the terms could not be reached within a reasonable time period, the Government may cease negotiations with MergeCo and invite other persons to undertake the New MTR Project.</p> <p><i>Natural extension of KCRC Railway (New KCR Project)</i></p> <p>For any New KCR Project, the Government may decide to adopt the ownership approach or the concession approach (under which the Government would fund the construction of the new railway and the operator would be granted a service concession to operate the new railway).</p> <p>For any New KCR Project in respect of which the Government decides to adopt the ownership approach, the Government and MergeCo would discuss the financial arrangement. If an agreement on the terms could not be reached within a reasonable time period, the Government may cease negotiations with MergeCo and invite other persons to undertake the New KCR Project on the basis of the ownership approach, or invite MergeCo to operate the New KCR Project through the concession approach in which case MergeCo shall operate that New KCR Project.</p> <p>For any New KCR Project in respect of which the Government decides to adopt the concession approach, the Government shall invite MergeCo to operate the New KCR Project.</p> <p>The Government acknowledges that MergeCo will require an appropriate commercial rate of return to be determined on a case-by-case basis for undertaking New KCR Projects under the concession approach.</p> <p>The provisions under [the heading of] natural extension of KCRC Railway will cease to have effect if MergeCo's franchise as it relates to the KCRC Railway only is revoked or expires.</p> <p><i>New project that is not natural extension of MTRC or KCRC Railway (New Separate Project)</i></p> <p>For any New Separate Project, the Government may decide to adopt the ownership approach or the concession approach.</p> <p>For any New Separate Project in respect of which the Government decides to adopt the ownership approach, the Government may:</p> <p>(a) discuss with MergeCo the financial arrangement for MergeCo to undertake the New Separate Project; or</p> <p>(b) award the New Separate Project through an open tender process.</p> <p>For any New Separate Project in respect of which the Government decides to adopt the concession approach, the Government may, in its absolute discretion, invite MergeCo and/or a third party to operate the New Separate Project.</p> <p>For each New Separate Project that the Government invites MergeCo to operate under a service concession approach, MergeCo shall operate that New Separate Project. The Government acknowledges that MergeCo will require an appropriate commercial rate of return to be determined on a case-by-case basis for undertaking New Separate Projects under the concession approach.</p> <p><i>Entrustment Arrangement</i></p> <p>MergeCo shall be entrusted with the design and construction of New Projects which are to be undertaken by MergeCo through the concession approach, subject to:</p> <p>(a) the Government's formal approval process; and</p> <p>(b) MergeCo and the Government agreeing on the price for such entrustment for each such New Project.</p> |

⁸ At the time of MTRCL's privatization, it was stipulated in the *Prospectus* that MTRCL would require an appropriate commercial rate of return, which would ordinarily be between 1% and 3% above weighted average cost of capital of MTRCL, on its investment in any new railway projects. See MTR Corporation (2000), p. 90.

⁹ See Environment, Transport and Works Bureau (2006b).

Table — Major changes proposed in the draft integrated Operating Agreement (cont'd)

| | Draft of the existing Operating Agreement | Draft integrated Operating Agreement |
|-----------------|--|---|
| Fare regulation | <p>Prior to changing the level of any fare¹⁰, the Corporation shall:</p> <p>(a) consider the level of public acceptance of any proposed change, based on passenger surveys;</p> <p>(b) consult the Transport Advisory Committee (TAC);</p> <p>(c) consult the Panel on Transport of the Legislative Council (Panel);</p> <p>(d) after the consultation pursuant to paragraphs (b) and (c) above, through its board of directors, resolve to approve the proposed fare change;</p> <p>(e) formally notify both TAC and the Panel within a reasonable period of time prior to the implementation of the new fare; and</p> <p>(f) make a public announcement of the new fare within a reasonable period of time prior to the implementation of the new fare.</p> | <p>This section contains a fare adjustment mechanism (FAM) and provides for the regulation of the fares of MergeCo in general. The relevant provisions are described in a paper entitled <i>Fare Adjustment Mechanism and Fare Reduction Proposal</i> which the Bills Committee considered on 2 November 2006.¹¹</p> <p>FAM as described in the paper entitled <i>Fair Adjustment Mechanism and Fare Reduction Proposal</i> is summarized as follows:</p> <p><u>FAM formula</u></p> <p>MergeCo fares¹² would be reviewed annually according to the following direct-drive formula –</p> <p>Overall fare adjustment rate = $0.5 * \Delta \text{CCPI} + 0.5 * \Delta \text{Wage Index} - \text{Productivity Factor}$,</p> <p>where ΔCCPI is the rate of change in the composite Consumer Price Index and $\Delta \text{Wage Index}$ is the rate of change in the Nominal Wage Index (Transport Services), both measured up to the end of the year preceding the year in which the relevant annual fare review is conducted. These two indices are published data of the Census and Statistics Department.</p> <p>The productivity factor would be a pre-agreed fixed number. It would have a value of 0.1% starting from the sixth year of the rail merger. This figure has been determined taking account of the fact that the scope for productivity gain would be limited due to heavy investment by MergeCo, particularly as the railway network is expanding. It will only be applied from the sixth year because MergeCo would be returning the initial productivity benefits of the merger to passengers by way of a fare reduction immediately upon the rail merger before it could fully realize the benefits of the synergies identified.</p> <p><u>Independent third party certifications</u></p> <p>Before the implementation of any fare adjustments under FAM, MergeCo would be required to provide the Government with two independent third party certifications certifying that the fare adjustments are in compliance with FAM. The independent experts to be appointed by MergeCo for this purpose should be qualified for appointment as an auditor under the Professional Accountants Ordinance (Cap.50). The selection of one of the two independent experts would be subject to agreement between MergeCo and the Government.</p> <p><u>Annual fare review cycle</u></p> <p>Fares would be reviewed under a fixed cycle on an annual basis under FAM. In line with the established practice of MTRCL, fare reviews would be conducted in the second quarter of the year and fare adjustments, if any, would be implemented in the middle of the relevant year, subject to compliance with the relevant FAM procedures and certifications.</p> <p>As provided for in the existing OA, MergeCo would be required to formally notify the Panel and TAC within a reasonable period of time prior to the implementation of the new fares.</p> <p><u>Trigger mechanism</u></p> <p>In any given year, a fare adjustment would only be triggered if the overall fare adjustment rate is 1.5% or more, or –1.5% or less. The unadjusted percentage would be carried over to the next annual fare review.</p> <p><u>Review of FAM</u></p> <p>FAM would be subject to review every five years upon request by either MergeCo or the Government.</p> |

¹⁰ MTRCL has autonomy to determine its own fares without any requirement to obtain the approval of the Government or any other body.

¹¹ See Environment, Transport and Works Bureau (2006a).

¹² FAM would apply to fares of all existing and new railway lines on the integrated MTR/KCR network (other than the Airport Express Line (AEL), Tung Chung Cable Car, intercity and freight services, and those new railway lines which are not natural extensions of the MTR or KCR railways and are not intended for the use of daily commuters for domestic travel) as well as the fares of Light Rail and KCRC bus service within the North-west Transit Service Area.

Table — Major changes proposed in the draft integrated Operating Agreement (cont'd)

| | Draft of the existing Operating Agreement | Draft integrated Operating Agreement | |
|--------------------------------|--|---|----------------------------------|
| Performance requirements | Existing performance requirements of MTR and KCR Railways: | | |
| | Performance criteria ⁽¹⁾ | Performance requirements | |
| | | MTR (MTR urban lines and Airport Express Line [AEL]) | KCR (East Rail and West Rail) |
| | (a) Train service delivery | 98.5% | 98.5% |
| | (b) Passenger journeys on time | 98.5% (98% for Airport Express Line) | 98% |
| | (c) Train punctuality | 98% | 98% |
| | (d) Add-value machine reliability | 95.5% | 98% |
| | (e) Ticket-issuing machine reliability | 93% | 97% |
| | (f) Ticket-gate reliability | 97% | 97% |
| | (g) Escalator reliability | 98% | 98% |
| (h) Passenger lift reliability | 98.5% | 98% | |
| | Note: (1) The performance levels are calculated by applying the following formulae for each month in a calendar year and then calculating the mean thereof: For item (a): $\frac{\text{Actual train trips in a month}}{\text{Scheduled train trips in a month}} \times 100\%$ For item (b): $\frac{\text{Incoming patronage in a month} - \text{Passengers in a month delayed by at least 5 minutes}}{\text{Incoming patronage in a month}} \times 100\%$ For item (c): $\frac{\text{Actual AEL/MTR/KCR train trips in a month} - \text{AEL/MTR/KCR train trips in a month delayed by at least y minutes}}{\text{Actual AEL/MTR/KCR train trips in a month}} \times 100\%$ Where y = 5 for AEL; 2 for MTR; and 3 for KCR For item (d) to (h): $\frac{\text{Total operating hours in a month for the relevant equipment} - \text{Total non-operating hours in a month for the relevant equipment}}{\text{Total operating hours in a month for the relevant equipment}} \times 100\%$ | | |
| | Performance requirements for MergeCo: | | |
| | Performance criteria | Performance requirements | |
| | (a) Train service delivery | 98.5% | |
| | (b) Passenger journeys on time | 98.5% | |
| | (c) Train punctuality | 98% | |
| | (d) Add-value machine reliability | 98% | |
| | (e) Ticket-issuing machine reliability | 97% | |
| | (f) Ticket-gate reliability | 97% | |
| | (g) Escalator reliability | 98% | |
| | (h) Passenger lift reliability | 98.5% | |
| | Remark: The formulae for calculating performance criteria remain unchanged. | | |

Table — Major changes proposed in the draft integrated Operating Agreement (cont'd)

| | Draft of the existing Operating Agreement | Draft integrated Operating Agreement |
|--------------------------|--|---|
| Customer service pledges | <p>The customer service pledges relate to:</p> <ul style="list-style-type: none"> (a) train service delivery; (b) passenger journeys on time; (c) train punctuality; (d) train reliability; (e) ticket reliability; (f) add-value machine reliability; (g) ticket-issuing machine reliability; (h) ticket-gate reliability; (i) escalator reliability; (j) passenger lift reliability; (k) temperature and ventilation levels; and (l) railway cleanliness, or as otherwise agreed between the Government and the Corporation from time to time. | <p>In addition to the customer service pledges set out in the draft of the existing OA, there is a new customer service pledge, namely passenger enquiry response time.</p> |

Table — Major changes proposed in the draft integrated Operating Agreement (cont'd)

| | Draft of the existing Operating Agreement | Draft integrated Operating Agreement |
|-------------------|--|--------------------------------------|
| Safety management | <p>The Corporation shall design, construct, operate and maintain the railway having, at all times, due regard to the safety of the railway and of persons using or employed on the railway to the reasonable satisfaction of the inspector¹³.</p> <p>The Corporation shall establish, operate and maintain a safety management system and continue to review, control and minimize safety risks as far as reasonably practicable.</p> <p><u>Independent safety expert</u></p> <p>The Corporation shall employ the services of an independent expert to review its safety management system at a regular interval of not more than three years, or such other period of time as the Corporation and the inspector may agree from time to time.</p> | No material change. |

¹³ An inspector means a person appointed as a railway safety inspector under section 26 of the Mass Transit Railway Ordinance (Cap. 556).

Table — Major changes proposed in the draft integrated Operating Agreement (cont'd)

| | Draft of the existing Operating Agreement | Draft integrated Operating Agreement |
|---------------------------|--|--|
| Disclosure of information | <p>The Government shall not disclose any restricted information¹⁴ unless it has first consulted the Corporation regarding its intention to do so.</p> <p>The Government shall procure that neither the Secretary [Secretary for the Environment, Transport and Works], the Commissioner [Commissioner for Transport], the inspector nor any other person acting for or on behalf of the Government discloses any restricted information unless he has first consulted the Corporation regarding his intention to do so.</p> <p>For the avoidance of doubt, either the Government or the Secretary may disclose particular restricted information after the Government or the Secretary (as appropriate) has consulted the Corporation regarding its or his intention to disclose that information.</p> <p>For the purposes of section 12(2) of the MTR Ordinance¹⁵, the Corporation agrees that, prior to the date of this Agreement [OA], it has been consulted regarding the intended disclosure by the Secretary or any other person authorized by the Secretary in writing as referred to in section 11(2)(b)¹⁶ of the MTR Ordinance of any information, other than restricted information, which might be furnished by the Corporation pursuant to section 10 or 11 of the MTR Ordinance and that the Secretary or such other person may, but shall be under no obligation to, disclose any such information without further consultation.</p> | <p>The scope of the restricted information has been expanded to cover information furnished to the Government pursuant to section 27 of the MTR Ordinance, which relates to general powers of inspectors.¹⁷</p> |

¹⁴ Restricted information means that: *information (in any form whatsoever) furnished to the Government, the Secretary [Secretary for the Environment, Transport and Works], the Commissioner [Commissioner for Transport], the inspector or any other person acting for or on behalf of the Government by the Corporation: (a) pursuant to section 10 or 11 of the MTR Ordinance; or (b) under this Agreement [OA] or by virtue of the exercise of any powers conferred by this Agreement [OA], which at the time that information was furnished to Government or the Secretary, the Commissioner, the inspector or any other person acting for or on behalf of Government (as the case may be) was specified by the Corporation to be unpublished commercially sensitive information.*

Section 10 of the *MTR Ordinance* mainly covers that: the Secretary may, by notice in writing to the Corporation, require the Corporation (a) to afford the Secretary sufficient facilities for obtaining information with respect to the business and affairs of the Corporation in connection with the franchise; and (b) in the manner and at the reasonable times specified in the notice, to furnish the Secretary with information with respect to the matters specified in (a) and afford to him facilities for the verification of that information, and to do so within a period specified in the notice, being a period that is reasonable in the circumstances.

Section 11(1) of the *MTR Ordinance* states that: *the Corporation shall keep, to the satisfaction of the Secretary, records in respect of the following matters relating to the railway – (a) the number and carrying capacity of trains in use or under maintenance; (b) the number of journeys undertaken and the total distance travelled; (c) the number of passengers carried; (d) the receipts; (e) details of any incident causing a service breakdown of 20 minutes or more; (f) the maintenance of trains; and (g) the number and types of trains, and their carrying capacity, on order or under construction together with details of the likely availability of such trains for use in the operation of the railway.*

¹⁵ Section 12(2) of the *MTR Ordinance* states that: *Neither the Secretary nor any other person shall disclose any information obtained pursuant to section 10 or 11 unless he has consulted the Corporation regarding his intention to do so.*

¹⁶ Section 11(2)(b) of the *MTR Ordinance* states that: *The Secretary may, by notice in writing to the Corporation, require the Corporation to permit the Secretary, or any other person authorized in writing by him, to inspect at any reasonable time all records kept by the Corporation in accordance with subsection (1), and to do so within a period specified in the notice, being a period that is reasonable in the circumstances.*

¹⁷ Section 27(3) of the *MTR Ordinance* states that: *The powers may be exercised by an inspector only for the purpose of: (a) ensuring the safety of the railway or railway premises; or (b) investigating an accident which involved the railway or which occurred on the railway or on railway premises, when the inspector is directed to do so pursuant to those regulations, and are exercisable in relation to an extension to the railway only if the extension has been brought into operation for public use.*

References

1. Environment, Transport and Works Bureau. (2006a) *Fare Adjustment Mechanism and Fare Reduction Proposal*. Paper submitted to the Bills Committee on Rail Merger Bill of the Legislative Council for discussion on 2 November 2006. LC Paper No. CB(1)195/06-07(01).
2. Environment, Transport and Works Bureau. (2006b) *Integrated Operating Agreement*. Paper submitted to the Bills Committee on Rail Merger Bill of the Legislative Council for discussion on 19 December 2006. LC Paper No. CB(1)520/06-07(01).
3. *Mass Transit Railway Ordinance (Chapter 556)*. (2000) Available from: http://www.legislation.gov.hk/blis_ind.nsf/e1bf50c09a33d3dc482564840019d2f4/ada3c49cf81641af4825691f00177a1e?OpenDocument [Accessed 21 December 2006].
4. *Minutes of Meeting of the Bills Committee on Mass Transit Railway Bill of the Legislative Council*. (2000) 6 January. LC Paper No. CB(1)1957/99-00.
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7. Transport Bureau. (1999a) *Legislative Council Brief: Mass Transit Railway Bill*. Available from: http://www.legco.gov.hk/yr99-00/english/bc/bc01/general/bc01_brf.htm [Accessed 22 December 2006].
8. Transport Bureau. (1999b) *Operating Agreement*. Paper submitted to the Bills Committee on Mass Transit Railway Bill of the Legislative Council for discussion on 23 November 1999. LC Paper No. CB(1)422/99-00(02).
9. Transport Bureau. (1999c) *Property Development Rights*. Paper submitted to the Bills Committee on Mass Transit Railway Bill of the Legislative Council for discussion on 18 November 1999. LC Paper No. CB(1)395/99-00(02).
10. Transport Bureau. (2000) *Operating Agreement*. Paper submitted to the Bills Committee on Mass Transit Railway Bill of the Legislative Council for discussion on 6 January 2000. LC Paper No. CB(1)717/99-00(02).

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