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Extract

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**Report of the Bills Committee
on Rail Merger Bill**

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Fare Regulation

54. At present, both MTRCL and KCRC have fare autonomy, and they set their fares in accordance with prudent commercial principles, having regard to, inter alia, economic conditions, competition from other transport modes and whether the services are value for money. In the context of the rail merger exercise, MTRCL and KCRC have agreed that MergeCo would adopt a formulaic approach for determining future fare adjustments to replace fare autonomy. The fare adjustment mechanism (FAM) after the rail merger would be based on the following formula :

Overall fare adjustment rate = 0.5 *ΔCCPI + 0.5 *ΔWage Index - Productivity Factor

where ΔCCPI is the change in the composite Consumer Price Index and ΔWage Index is the change in Nominal Wage Index (Transport Sector). Both indices are published data of the Census & Statistics Department. The productivity factor would be a pre-agreed fixed number. It would be set at 0.1% starting from the 6^{th} year of the rail merger.

55. Under the proposed FAM, fares would be reviewed and adjusted on an annual basis. There would be a trigger mechanism under which overall fare reduction or increase of less than 1.5% would be carried over to the next annual fare review. The overall fare adjustment rate calculated from the formula would apply to the fares of MergeCo as in one basket. However, MergeCo may determine the rate of adjustment of individual railway fares which shall be within the range of ± 10 percentage points from the overall fare adjustment rate ("the permitted range") provided that the adjustment rate of weighted average fare of all individual fares must be equal to the overall fare adjustment rate derived from the FAM formula and that there shall be no increase of any individual railway fares if the overall fare adjustment rate is negative.

56. The Bills Committee notes that fares of all existing and new railway lines on the integrated MTR/KCR network (other than the Airport Express Line, Tung Chung Cable Car, intercity and freight services, promotional fares 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 TSA bus service will be subject to the FAM (i.e. Controlled Fares).

57. The Bills Committee has examined the control mechanism for ensuring the accuracy of calculations under the FAM. The Administration has advised that under the IOA, MergeCo shall, in each year and at its own cost, appoint two independent third party experts for the purpose of certifying whether the decision of MergeCo on the adjustments to Controlled Fares in the relevant year complies with the FAM. Unless the FAM dictates that there shall be no adjustment to the Controlled Fares in a particular year, MergeCo shall at its own cost appoint an additional independent expert for the fare review in that year. The selection of one of the independent experts shall be subject to Government's agreement.

Adjustment of individual fares within the permitted range

58. The Bills Committee notes that there are strong views among members on the proposal to allow MergeCo to adjust individual fares within the range of ± 10 percentage points from the overall fare adjustment rate under the proposed FAM. Members are concerned about the uncertainty created by the proposed flexibility which would render the FAM no longer transparent and objective. They are also worried that passengers in remote areas where competition is not keen would be subject to a higher rate of fare increase. In the extreme case, the gap between individual fares after applying the flexibility of ±10 percentage points from the overall fare adjustment rate can be as high as 20%. This will give rise to social discord. The Bills Committee has therefore requested the Administration to reduce the scope of flexibility granted to MergeCo for adjusting the rate of fare increase/decrease for individual fares from the overall

adjustment rate to ±5 percentage points. Some members even consider that it is unfair to allow MergeCo to compete with other public transport services through such predatory marketing practices, and hence, the flexibility granted to MergeCo to adjust individual fares should be repealed.

59. The Administration has advised that as part of the overall merger package, the existing fare autonomy of the two railway corporations will be replaced with the FAM upon implementation of the rail merger. Fares of MergeCo would be adjusted according to a direct-drive formula which is linked to changes in consumer price index and wage index as well as a pre-determined productivity factor. As compared with the existing fare autonomy, the FAM would restrict MergeCo's discretion to increase its fares and mandate MergeCo to reduce fares under specified circumstances. The overall fare adjustment rate by MergeCo would be capped at the overall fare adjustment rate derived from the FAM formula, i.e. the adjustment rate of weighted average fare of all individual fares must equal to the overall fare adjustment rate derived from the FAM formula. The FAM itself has already ensured that MergeCo would not obtain additional financial benefits even if it decides to exercise flexibility in adjusting individual fares at different rates within the permitted range. Besides, the railways face keen competition from other public transport services. MergeCo needs to be able to cope with market changes. It is therefore necessary that MergeCo should be able to retain certain flexibility in adjusting individual fares. In the course of determination, MergeCo must take into account public affordability of its fares, otherwise its passengers would switch to other modes which would not be in MergeCo's own interest. From a practical point of view, given that railway fares are set to the nearest of $0.1 and $0.5 for Octopus and single journey tickets respectively, it is not practicable to require MergeCo to adjust all individual fares by the same overall adjustment rate across the board.

60. The Administration also advises the Bills Committee that flexibility for different adjustment rates to individual fares is not unique to the railway corporations, and there were cases in past years where the actual adjustment rates of individual franchised bus routes deviated from the overall approved fare adjustment rate by more than ±10 percentage points.

61. To address members' concerns, the Administration advises that after further discussion with MTRCL, the degree of flexibility granted to MergeCo to adjust individual fares by not more than ± 10 percentage points will be revised to ± 5 percentage points from the overall fare adjustment rate. The Bills Committee notes that some members welcome the revised proposal, whilst some other members take the view that the permitted range of flexibility should be reduced further and the Administration and MergeCo should monitor the situation to ensure that long-haul passengers in Tin Shui Wai, Tuen Mun, Yuen Long and Tung Chung would not be adversely affected as a result of applying the

flexibility to adjust individual fares within the permitted range.

Suggestions to refine the fare regulatory framework

62. The Bills Committee has examined various proposals put forward by members to refine the fare regulatory framework after the rail merger. Some members acknowledge that the replacement of fare autonomy by a FAM is an improvement, whilst some consider that MergeCo should use part of the profits from property development to set up a fare stabilization fund to moderate the rate of fare increase and some others consider that railway fares should be subject to the approval of LegCo or the Executive Council. There are also suggestions that MergeCo should consider other factors such as prevailing economic conditions, its operating environment and public affordability before determining the rate of fare increase or decrease under the FAM, or imposing a cap on the rate of fare increase.

63. The Administration and MTRCL have advised the Bills Committee that railway development is highly capital intensive, not only during the initial construction phase of the rail infrastructures but also throughout the life of the operation. To ensure long-term sustainability for provision of safe and quality passenger service and also to meet the demands of a listed company, MTRCL needs to earn a commercial return. For a new railway project that will benefit the public but will not be financially viable, there is a funding gap to be bridged. The granting of property development rights is a way for bridging the funding gap of new railway projects. The funding through property development rights has enabled MTRCL to meet the high capital costs of the rail infrastructures whilst keeping fares affordable. The prevailing fare structure has always been used as the basis for the calculation of funding gap requirement and correspondingly the amount of property rights granted to MTRCL as the Government's means to providing funding. In other words, for railway projects where property rights were granted, the initial fares of the new railways concerned have already taken into account the expected property profits. Given that the profits from property developments arising from the application of the rail-and-property model for railway development have been taken into account in the setting of the initial fares of the relevant railways, using such profits to set up a fare stabilization fund under the FAM would have the effect of double-counting the property development profits.

64. The Bills Committee has also explored the feasibility of subjecting fare adjustments to the approval of the Chief Executive in Council or LegCo. MTRCL has advised that in view of the drastic change from fare autonomy to price regulation by FAM, they do not agree to subject fare adjustments of MergeCo to approval by Government or LegCo. It also considers it inappropriate to impose an artificial cap on the overall fare adjustment rate.

According to MTRCL, fare levels after the rail merger would be adjusted according to a formula which is linked to changes in consumer price index and wage index as well as a pre-determined productivity factor. These indices are objective and transparent. In general, this formula can reflect economic conditions in Hong Kong and affordability of the public. The addition of other factors for consideration would be inconsistent with the regulatory approach of adopting a direct-drive fare adjustment formula.

65. MTRCL has also referred to the submission put forward by Professor RIDLEY of Imperial College, London on the merits of the proposed FAM. Professor RIDLEY is of the view that "The formula, by allowing an automatic annual adjustment, protects the interests of the workforce of the metro by providing income that can support fair wages, protects the legitimate interests of shareholders who receive a fair return on the capital they provide, protects the interests of taxpayers by giving strong management incentives to deliver efficiency, and protects the interests of the travelling public against unjustified fares increases…… Therefore, in order to facilitate stable business decisions by the metro to deliver sustained, long-term service quality, it is essential that the agreed formula for annual adjustments in fares is adopted automatically and in full."

66. The Bills Committee has also examined whether the Government would have measures to influence the decision of MergeCo in respect of fare increase in case of special circumstances such as serious economic downturn. The Administration has pointed out that there is already a mechanism which provides for the handling of very special circumstances that affect public interest. Under MTRO, the Chief Executive in Council has power to give direction to MTRCL in relation to any matter concerning the franchise if he considers the public interest so requires. There is no specific restriction on the scope of such direction. MTRO also stipulates that the Government is liable to pay compensation to the Corporation for loss or damage sustained by the Corporation arising from its compliance with the direction.

67. Regarding consultation with LegCo on fare-related matters after the rail merger, the Administration points out that there is also a provision in the IOA requiring MergeCo to notify the Panel on Transport of LegCo in writing before implementation of fare adjustment. MTRCL has advised that MergeCo would be prepared to attend meetings of the Panel on Transport of LegCo to answer questions on fare adjustment.

Hypothetical application of FAM

68. The Bills Committee has examined the hypothetical changes of railway fares over the past 22 years by applying the FAM formula to see how it works.

The Bills Committee notes the Administration's view that it is not appropriate to artificially apply the fare adjustment formula retrospectively as if it had been agreed for application at that time, which it was not, and compare the hypothetical result with the actual fare increases in the past period. According to the Administration's rough analysis on the hypothetical calculations for different time periods (Appendix II to LC Paper No. CB(1) 258/06-07(01)), the FAM would have resulted in :

(a) overall reduction in fares by 0.5% or 5.7%, as compared to actual cumulative increase of 13.8% in railway fares during the last 10 years;

(b) lower cumulative fare increase rate than actual during the last 15 years;

(c) fare increase rates comparable to the actual during the last 18 or 22 years; and

(d) similar results are obtained if the calculations are based on simple average rate of fare adjustments per annum over the relevant time periods.

Determination of the productivity factor under the FAM

69. The Bills Committee has examined the basis for determining the productivity factor under the FAM. According to the Administration, there is no single authoritative methodology recognized internationally for measuring productivity of the railways. This is due to special characteristics of the railway industry which involves heavy investment and long payback period. If the Administration adopts the same approach used for calculating the productivity gain of the franchised bus industry in Hong Kong to measure the productivity performance of the railway industry, it would yield a negative result of –2.6% per annum. The net effect is that this would amplify future fare increases or decrease the level of fare reduction. This would not be in the interest of the travelling public. Under the proposed FAM formula, the productivity factor would be set at a positive value of 0.1%, which would have the effect of moderating future rail fare increase (or increasing the level of future rail fare reduction, as the case may be) by 0.1%. In considering that MergeCo would return the benefits of the merger synergies to passengers through fare reduction immediately upon the merger before the expected synergies take full effect, the productivity value of 0.1% would take effect starting from the 6^{th} year of the merger.

Fare reduction package

70. In the context of the rail merger, a fare reduction package is proposed as

an integral part of the FAM. According to the Administration, the fare reduction package is made possible due to the synergy that could be brought about by the merger. MergeCo will reduce the railway fares immediately from the first day of the merger as follows:

(a) abolition of second boarding charge ranging from $1 to $7;

(b) further global fare reduction of $0.20 for all Octopus card users paying full fares;

(c) an extra $1 reduction for medium/long distance journeys charging $12 or above;

(d) for all journeys charging $12 or above, if (a), (b) and (c) above when combined result in less than a 10% reduction, there would be a further reduction to achieve a minimum of a 10% reduction for all these journeys; and

(e) for all journeys charging between $8.50 and $11.90, if (a) and (b) above when combined result in less than a 5% reduction, there would be a further reduction to achieve a minimum of a 5% reduction for all these journeys.

71. MergeCo will also provide a concessionary fare of $2 per trip in the first year after the rail merger for senior citizens travelling on the railway network on Sundays and public holidays. The existing student fare discount would be maintained, i.e. students would continue to enjoy half fares when travelling on MTR.

Effective period of fare reduction

72. The Bills Committee has expressed grave concern that railway fares could be adjusted upwards in accordance with the FAM shortly after the rail merger, notwithstanding the proposed fare reduction on Day One of the merger and the undertaking given by the two railway corporations not to increase their fares for two years starting from April 2006. Members are concerned that as the two railway corporations have not reduced their fares during the past deflationary period, there is already room for them to reduce railway fares, not to mention the fact that they are making profit each year. In order to enable the travelling public to enjoy a longer period of fare reduction, they consider that the two-year commitment not to increase railway fares should count from passage of the Bill instead of the signing of the MoU (i.e. April 2006). To this end, the Bills Committee has passed a motion strongly requesting the Government to seek an agreement with the two railway corporations to reduce railway fares immediately,

and to formally activate the FAM, which allows for increase and reduction in railway fares, two years after the passage of the Bill.

73. The Administration advises that the proposed fare reduction which amounts to an annual saving of $600 million for the public is made possible only because of synergies to be achieved as a result of the merger. The two corporations have estimated that the synergies arising from the merger is only $450 million per annum. In other words, the revenue foregone due to fare reduction from the first day of the merger has already exceeded the estimated amount of potential synergies.

74. MTRCL also points out that it has already made considerable concession by agreeing to replace fare autonomy with FAM upon merger. By reason of the on-going discussion of the rail merger, the Corporation has frozen its fares for more than three years since February 2004. MTRCL has indicated that it is very difficult for the Corporation to absorb the impact of a prolonged period of fare freeze following the proposed fare reduction on its operation. Further, rail transport fares are already at a very competitive level before any fare reductions proposed upon implementation of the merger.

75. After several rounds of discussion between the Administration and MTRCL, MTRCL finally offers to extend the effective period of its commitment not to increase fares from April 2008 to June 2009 on the basis that the rail merger will be implemented.

Scope of the fare reduction package

76. The Bills Committee has examined why the proposed fare reduction would only apply to domestic MTR and KCR railway lines but not fares of the Airport Express Line (AEL) and Lo Wu as well as the Light Rail (LR) services. The Bills Committee notes that Tuen Mun and Yuen Long District Councils have expressed grave concern about the Administration's proposal to exclude the LR services from the fare reduction package. The Bills Committee has urged the Administration and the two railway corporations to review the matter, and to increase also the rate of fare reduction to benefit the travelling public.

77. According to the Administration, in the light of the potential synergies arising from the rail merger, the travelling public will get immediate benefit out of the rail merger. The objective of the fare reduction package is to benefit local commuters in domestic travels. For AEL service, it is not used by commuters as a form of daily travel, whereas airport workers who are frequent users of AEL are already provided with substantial discount. As regards Lo Wu service, its main service target 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 (and Tsim Sha Tsui East now). Reduction of Lo Wu fares would have a negative impact on the East Rail domestic fares which would affect over 660,000 daily commuters and would also adversely affect the financial position of MergeCo.

78. Regarding the LR system, the Administration points out that it has been in deficit requiring cross-subsidization from KCRC's other operations. There is little scope for fare reduction which would affect the sustainability of the LR system. Besides, it is noted that nearly one-third of LR passengers are already enjoying free service for interchange with West Rail, and frequent LR users can benefit from the "Light Rail Frequent User Bonus Scheme" which provides fare concession equivalent to about 10% fare discount. The Bills Committee considers that as LR is the primary mode of public transport services in the North-west TSA, there is an urgent need for the Administration and MergeCo to review the role of LR in the overall public transport services market and make necessary improvements so as to cater for the transport needs of residents in the areas at affordable prices.

Concessionary schemes

79. The Bills Committee notes that some members are very concerned about the possibility of gradual cancellation of promotional and concessionary fares for passengers after the rail merger as this would offset the benefits associated with the provision of fare reduction in the context of the rail merger. The Bills Committee has requested the two railway corporations to give an undertaking not to cancel the promotional and concessionary fares, and consider introducing new concessionary monthly ticket schemes for the benefit of the travelling public.

80. The two railway corporations have pointed out that they have introduced a number of fare concessionary schemes over the past few years in the light of the overall economic environment of Hong Kong, their marketing strategy and passenger demand so as to lessen the burden of the travelling public. These include MTR Fare Savers in many districts, East Rail/West Rail One-Month Pass, West Rail Discovery Pass, East Rail/West Rail travel package, Child/Senior Citizen $2 special concession on West Rail on Saturdays, Sundays and public holidays, and other inter-modal discounts for interchange. The two corporations have indicated that the fare concessionary schemes would continue to be reviewed regularly in the light of market conditions and passenger demand. The Administration also advises that according to the spirit of free enterprise, it will be the commercial decision of railway corporations as to whether they will offer concessions.

81. The Bills Committee has also examined the requests put forward by members for including a new clause in the IOA, requiring MergeCo to provide half-fare concession to full-time students aged 25 or below, senior citizens aged 65 or above and people with disabilities (PwDs). The Bills Committee notes that some members are of the view that as the two railway corporations are making profits each year, they shall take the lead to fulfill their corporate social responsibility and offer fare concessions to the above groups of passengers, particularly PwDs. Government, being the sole owner of KCRC and the majority shareholder of MTRCL, should also exercise its influence in the respective Management Boards to request the two railway corporations to offer concessionary fares to PwDs.

82. The Administration advises that through its discussion with MTRCL on the rail merger, MTRCL has agreed to continue retaining existing half-fare concession for student passengers using MTR service and half-fare concession for senior citizens using MTR and KCR services after the rail merger. MTRCL however has advised that fare concessions are their own initiatives and thus it is not appropriate to stipulate this as a requirement in the IOA. The Bills Committee notes that MTRCL does not agree to add the proposed new provision in the IOA.

83. Regarding the provision of concessionary fares to PwDs, the Administration has pointed out that public transport services in Hong Kong are provided by the private sector under prudent commercial principles without Government subsidy. Should the Government make it mandatory for the operators to offer any particular fare concession, the income of the operators may drop which would pose pressure for fare increase. This would not be in the interest of the public. The Administration is aware of members' concern about the matter and is presently considering ways to take forward the matter in collaboration with the Health, Welfare and Food Bureau. The Administration would continue to discuss the matter with the Subcommittee to Study the Transport Needs of and Provision of Concessionary Public Transport Fares for Persons with Disabilities. As a means to assist the PwDs to access the MTR, MTRCL has stressed that they have put into considerable resources in improving station facilities. Over $400 million has been spent on retrofitting new station facilities and a further $100 million will be committed for the next five years.

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