

LEGISLATIVE COUNCIL BRIEF

Tate's Cairn Tunnel Ordinance
(Chapter 393)

Application for Toll Increases by Tate's Cairn Tunnel Company Limited

INTRODUCTION

At the meeting of the Executive Council on 7 May 2013, the Council **ADVISED** and the Chief Executive **ORDERED** that the Tate's Cairn Tunnel Company Limited (TCTC)'s application for toll increase should be approved, and that the new tolls should take effect from 1 August 2013.

JUSTIFICATIONS

Background

2. TCTC was granted a franchise under the Tate's Cairn Tunnel Ordinance (the Ordinance) to build and operate the Tate's Cairn Tunnel (TCT) for 30 years starting from July 1988, inclusive of the construction period. The tunnel was built at a cost of \$1.96 billion and was opened to traffic in June 1991. TCTC's franchise will expire in July 2018.

3. Section 36(3) of the Ordinance provides that the tolls specified in the Schedule to the Ordinance may be varied by agreement between the Chief Executive-in-Council and TCTC. If an agreement cannot be reached, either party may resort to arbitration. A copy of section 36 of the Ordinance is at **Annex A**.

TCTC's Application for Toll Increases

4. So far, TCTC has had six toll increases which came into effect in May 1995, November 1996, January 2000, August 2005, November 2008 and December 2010 respectively.

5. TCTC submitted on 26 March 2012 an application for a toll increase of \$3 for private car, and proportionate increases for other vehicle types (the proposed increases range from \$2 for motorcycle to \$6 for double-decker bus), with effect from 1 July 2013. If approved, the magnitude of toll increases for different vehicle types would range from 17% to 24%, and the weighted average rate of toll increases¹ would be 19.6%. The toll increases would enable the company to achieve a nominal Internal Rate of Return on equity after tax (IRR) of 6.87% over the 30-year franchise period.

6. Upon receipt of TCTC's toll increase application, the Administration has urged the company to reconsider the need for the toll increases and whether the proposed magnitude of increase is excessive. We have asked the company to reduce the magnitude of the toll increases and minimise the impact of the toll increases on public transport services. TCTC subsequently agreed to reduce the magnitude of toll increases and submitted a revised toll increase application on 8 November 2012 as follows –

- (i) \$2 increase for all types of vehicles and additional axle except for motorcycle; and
- (ii) \$1 increase for motorcycle.

7. The existing tolls and new tolls proposed by TCTC are listed below –

¹ The weighted average rate of toll increases represents the percentage increase in total toll revenue calculated based on the proposed toll rates and the actual traffic of Tate's Cairn Tunnel.

	Motor -cycle	Private car & taxi	Public light bus	Private light bus & light goods vehicle	Medium & heavy goods vehicle	Single- decker bus	Double- decker bus	Extra axle
Existing Tolls	\$12	\$15	\$21	\$22	\$26	\$29	\$32	\$19
<i>Original Proposed Tolls</i>	<i>\$14</i>	<i>\$18</i>	<i>\$26</i>	<i>\$26</i>	<i>\$31</i>	<i>\$35</i>	<i>\$38</i>	<i>\$23</i>
<i>Increase % (Increase magnitude)</i>	<i>17% (\$2)</i>	<i>20% (\$3)</i>	<i>24% (\$5)</i>	<i>18% (\$4)</i>	<i>19% (\$5)</i>	<i>21% (\$6)</i>	<i>19% (\$6)</i>	<i>21% (\$4)</i>
Revised Proposed Tolls	\$13	\$17	\$23	\$24	\$28	\$31	\$34	\$21
<i>Increase % (Increase magnitude)</i>	<i>8% (\$1)</i>	<i>13% (\$2)</i>	<i>10% (\$2)</i>	<i>9% (\$2)</i>	<i>8% (\$2)</i>	<i>7% (\$2)</i>	<i>6% (\$2)</i>	<i>11% (\$2)</i>

A briefing paper prepared by TCTC on its toll increase application is at **Annex B**.

TCTC's Financial Position

8. By the end of June 2012, TCTC had accumulated profit of \$833 million, representing a shortfall of \$3,661 million as compared with the expected cumulative profit of \$4,494 million in the company's base case projection when bidding for the franchise. The difference between the actual profit/loss of TCTC and base case projections over the years is set out below –

Profit & Loss (in \$million)			
Year²	Base Case Projection (A)	Actual Profit/Loss (B)	Difference (B-A)
1991/92	(149)	(176)	(27)

² TCTC's financial year is from 1 July to 30 June of the following year.

Profit & Loss (in \$million)			
Year²	Base Case Projection (A)	Actual Profit/Loss (B)	Difference (B-A)
1992/93	(148)	(159)	(11)
1993/94	(147)	(147)	0
1994/95	(69)	(143)	(74)
1995/96	(56)	(94)	(38)
1996/97	41	(71)	(112)
1997/98	66	(43)	(109)
1998/99	88	(41)	(129)
1999/2000	194	(10)	(204)
2000/01	212	18	(194)
2001/02	265	92	(173)
2002/03	356	103	(253)
Deferred tax adjustment ³	-	120	120
2003/04	370	97	(273)
2004/05	372	112	(260)
2005/06	448	142	(306)
2006/07	447	146	(301)
2007/08	446	157	(289)
2008/09	446	156	(290)
2009/10	443	177	(266)
2010/11	442	189	(253)
2011/12	427	208	(219)
Cumulative	4,494	833	(3,661)

9. TCTC started to make an operating profit in 2000/01. It repaid its bank loan in October 2004 and shareholders' loan in 2004/05. It wiped off the accumulated loss by 2007/08, and had an accumulated profit of \$833

³ The deferred tax adjustment was a result of the adoption of a revised accounting standard.

million at the end of 2011/12. The company started to pay dividends in 2008/09.

Reasons for Financial Under-performance

10. TCTC attributes the financial under-performance to the lower-than-expected toll revenue due to the following –

- (a) increasing toll disparity between the Lion Rock Tunnel (LRT) and the Tate’s Cairn Tunnel (TCT) (According to TCTC, one of the key assumptions in planning the franchise bid in 1988 was that the tolls for LRT would be increased broadly in line with inflation. This scenario has not materialised.);
- (b) relocation of the airport;
- (c) diversion effect due to an increase in transportation modes and road choices, for instance, the opening of Route 3 (Tai Lam Tunnel), Ma On Shan Railway and Route 8; and
- (d) migration of industrial/manufacturing activities to the Mainland.

11. A comparison of its base case traffic forecast in the franchise bid and the actual traffic throughput is shown below –

Daily Average Traffic Volume (in thousands)			
Year²	Base Case Forecast	Actual	Difference
1991/92	64.7	56.6	-12%
1992/93	69.2	68.7	-1%
1993/94	73.8	79.6	+8%
1994/95 ⁴	78.3	80.7	+3%
1995/96	82.9	75.5	-9%
1996/97 ⁴	87.0	71.9	-17%
1997/98	90.6	69.5	-23%
1998/99	93.1	62.5	-33%
1999/2000 ⁴	93.8	64.1	-32%

⁴ Six toll increases took effect in May 1995, November 1996, January 2000, August 2005, November 2008 and December 2010 respectively.

2000/01	93.8	64.0	-32%
2001/02	93.8	63.5	-32%
2002/03	93.8	61.5	-34%
2003/04	93.8	61.2	-35%
2004/05	93.8	60.0	-36%
2005/06 ⁴	93.8	55.3	-41%
2006/07	93.8	55.6	-41%
2007/08	93.8	56.4	-40%
2008/09 ⁴	93.8	51.5	-45%
2009/10	93.8	51.5	-45%
2010/11 ⁴	93.8	53.0	-43%
2011/12	93.8	54.6	-42%

The Administration's Assessment

(A) Guiding Principle – Reasonable but not Excessive Remuneration

12. On the basis of the Base Toll Proposal which accompanied its franchise bid, the company expected that it would achieve a nominal IRR of 13.02% over the 30-year franchise period. In considering TCTC's franchise bid in 1988, the Government agreed to the initial tolls but gave no undertaking in respect of subsequent toll adjustments. Nor was there any agreement on a guaranteed rate of return.

13. TCTC's target IRR was the lowest among the four Build-Operate-Transfer tunnels in Hong Kong. Route 3 (Country Park Section) had a target IRR of 15.18%, while the targets for the Eastern Harbour Crossing (EHC) and the Western Harbour Crossing were both 16.5%. As it stands, TCTC will only achieve a nominal IRR of 6.61% over the 30-year franchise period based on the current forecast at existing toll level. TCTC projects that it will be able to achieve a nominal IRR of 6.76% over the 30-year franchise period should the revised toll increase application be approved.

14. The Ordinance stipulates that if TCTC's toll increase application is submitted for arbitration, the arbitrator shall be guided by the need to ensure that TCTC is reasonably but not excessively remunerated for its obligations under the Ordinance. While the Ordinance has not stipulated what constitutes "reasonable but not excessive remuneration" for TCTC, having regard to the

outcome of the previous toll increase arbitrations of EHC, which has a similar toll adjustment and arbitration mechanism as TCT, and the scale of the project in the context of a long term infrastructure investment, we consider that a nominal IRR of 6.76% (or real IRR of 3.38% after discounting the inflation factor, according to our estimation) under TCTC's current toll increase application would not be unreasonable or excessive.

(B) Traffic Implications

15. In 2012, TCT had an average daily throughput of 55 800 vehicles, against its design capacity of 78 500 vehicles. TCTC has estimated that with its proposed toll increases, about 500 vehicles will be diverted to LRT, and fewer than 100 vehicles would be diverted to Tai Po Road and Route 8 between Cheung Sha Wan and Shatin per day. Our assessment is that the traffic impact of the proposed toll increases on the road system linking Shatin and Kowloon would unlikely be significant and commuters have a choice of alternative routes as well as alternative transport modes.

(C) Public Affordability and Acceptability

16. Under TCTC's revised toll increase proposal (i.e. \$2 increase for all types of vehicles and additional axle except for motorcycle; and \$1 increase for motorcycle), the percentage of increase ranges from 6% for double-decker bus to 13% for private car and taxi, with a weighted average rate of toll increases of 11.1% (down from 19.6% in the original application). This weighted average increase percentage is slightly lower than the cumulative change in the Composite Consumer Price Index (CCPI) since the last toll increases from 25 December 2010 up to end June 2013 (proposed date for the toll increases in TCTC's application is 1 July 2013), which is estimated to be 12.3%⁵. The Median Monthly Household Income (MMHI)⁶ has increased by 15.3% from \$18,300 for the fourth quarter (Q4) of 2010 to \$21,100 for Q4 of

⁵ Based on the latest forecast of CCPI announced in the 2013/14 Budget which has revised upward the 2013 inflation from 3.5% to 4.5%, the estimate of cumulative change in CCPI has been updated from 11.3% to 12.3%. The estimated figure of 11.3% prior to the announcement of 2013/14 Budget on 27 February 2013 was previously used in the discussion paper issued to the Panel on Transport of the Legislative Council and TAC for their meetings on 14 December 2012 and 26 February 2013 respectively.

⁶ MMHI is published on a quarterly basis.

2012. The above considerations notwithstanding, the revised toll increases may still incur criticisms by some members of the public.

(D) Service Performance and Cost

17. According to TCTC's annual survey of customers' opinions, over 96% of the customers surveyed considered TCTC's service satisfactory. TCTC has been reducing its operating costs (excluding rates and royalty paid to the Government) in every year over the past fifteen years, from about \$86 million in 1996/97 to about \$64 million in 2011/12. Even though TCT is the longest road tunnel in Hong Kong, its operating costs are the lowest among other BOT tunnels.

(E) Arbitration

18. Under the Ordinance, if an agreement on the toll increases cannot be reached between the Government and TCTC, either party may resort to arbitration under the Arbitration Ordinance (Chapter 341). Therefore, TCTC has the right to resort to arbitration if its application for the toll increases is rejected by the Chief Executive-in-Council. In all previous six toll increase applications, the Government and TCTC have been able to reach agreement and arbitration was never resorted to. In this context, the Transport Advisory Committee (TAC) has advised that it would be desirable where possible for the two parties to reach an agreement on the toll increases rather than to incur public expenditure by way of legal costs in resolving their differences through arbitration.

Timing of Implementation

19. The Chief Executive-in-Council has approved TCTC's revised toll increase application to take effect on 1 August 2013. This will allow sufficient time for the gazette notice⁷ to be made by the Commissioner for

⁷ The gazette notice (a legal notice) is made by the Commission for Transport in exercising his/her statutory duty under section 36(7) of the Ordinance to implement an agreement between Chief Executive-in-Council and the tunnel company on toll variation with Chief Executive-in-Council's approval of the toll increase application by the tunnel company. The gazette notice is subject to negative vetting.

Transport in accordance with section 36(7) of the Ordinance to promulgate the new tolls to go through the Legislative Council's negative vetting process.

IMPLICATIONS OF THE PROPOSAL

20. The financial and economic implications of the proposed toll increases are at **Annex C**. The proposed toll increase is in conformity with the Basic Law, including the provisions concerning human rights. It has no environmental, sustainability, productivity, competition, family or civil service implications.

PUBLIC CONSULTATION

21. TCTC's revised toll increase application was discussed at the meeting of the Legislative Council Panel on Transport on 14 December 2012. Panel Members expressed objection to the proposed toll increases. One member considered that the current IRR of 6.61% (nominal) to be achieved by TCTC before the end of its franchise without any toll increase a good return rate in the current economic environment. Another member suggested that the Administration should consult the public on extending TCTC's franchise in return for a limited rate of toll increases by TCTC or buying back TCT.

22. TAC was consulted on TCTC's application in February 2013. TAC took into account all relevant factors⁸ and arrived at the view that TCTC's current application for toll increases is not unreasonable and is justified. TAC's detailed advice is set out in its letter to the Secretary for Transport and Housing at **Annex D**.

PUBLICITY

23. A press release will be issued before the publication of the gazette notice by the Commissioner for Transport on 16 May 2013.

⁸ Including the financial performance of TCTC, return on investment, traffic implications that might be brought about by the proposed toll increases, prevailing economic conditions, public acceptability and affordability.

ENQUIRIES

24. Any enquiries concerning this Brief can be directed to Ms Cordelia Lam, Principal Assistant Secretary for Transport and Housing, at 3509 8192.

Transport and Housing Bureau
May 2013

Annex A

Chapter: 393	Title:	TATE'S CAIRN TUNNEL ORDINANCE	Gazette Number:	L.N. 38 of 2011
Section: 36	Heading:	Company to charge approved tolls for use of tunnel	Version Date:	01/06/2011

(1) Subject to this Ordinance, the Company may demand and collect tolls in respect of the passage of motor vehicles through the tunnel.

(2) The tolls that may be collected under subsection (1) shall be those specified in the Schedule.

(3) The tolls specified in the Schedule may be varied-

- (a) by agreement between the Governor in Council and the Company; or
- (b) in default of agreement by submission of the question of the variation of tolls to arbitration under the Arbitration Ordinance (Cap 609) by either the Governor in Council or the Company. (Amended 17 of 2010 s. 112)

(4) On a submission to arbitration under subsection (3), the arbitrators shall be guided by the need to ensure that the carrying out by the Company of its obligations, or the exercise of its rights, under this Ordinance is reasonably but not excessively remunerative to the Company, having regard to-

- (a) any material change in the economic conditions of Hong Kong since the enactment of this Ordinance or, as the case may be, since tolls were last determined under this section;
- (b) the dismissal of any appeal by the Company made under section 53;
- (c) any material change in any other circumstances affecting the exercise by the Company of its rights under the franchise;
- (d) the effect of the introduction of, or alteration in,

- any tax or levy imposed on the use of the tunnel;
- (e) the project agreement; and
- (f) any other relevant matter.

(5) In determining for the purposes of subsection (4) whether the carrying out by the Company of its obligations, or the exercise of its rights has been reasonably but not excessively remunerative to the Company, the arbitrators shall, if there has been any failure by a guarantor under the further guarantee agreement to comply with the terms of that agreement, deem the Company to be in the financial position it would have been in had the further guarantee agreement been honoured, and subject to this subsection nothing in that subsection shall be deemed to render such failure a relevant matter which the arbitrators may take into consideration.

(6) Where under subsection (3)-

(a) the Governor in Council and the Company agree to a variation of the tolls; or

(b) in an award pursuant to a submission to arbitration it is determined that the tolls should be varied,

the tolls specified in the Schedule shall be varied in compliance with such agreement or award, as the case may be.

(7) The Commissioner shall, by notice in the Gazette, as soon as is practicable after such agreement or award as is referred to in subsection (6), amend the Schedule.

(Enacted 1988)

TATE'S CAIRN TUNNEL COMPANY LIMITED

TOLL INCREASE APPLICATION

Justification for Toll Rise

Tate's Cairn Tunnel (TCT) franchise was awarded on a "Build, Operate Transfer" (BOT) basis to attract investment from private sector for building infrastructure project in Hong Kong. About \$2 billion was invested to build the TCT. The TCT Ordinance has stated that a "reasonable but not excessive return" should result from this investment.

As at the end of June 2012 (i.e. after a period of 24 years since the start of the 30-year franchise in 1988), Tate's Cairn Tunnel Company Limited ("TCTC") has accumulated profit of \$833 million, lagging far behind the Base Toll Proposal in which an accumulated profit of \$4,494 million had been projected with the expected IRR of 13.02%. The deviation resulting from shortfalls in revenue was due to reasons beyond the Company's control.

TCTC has eliminated its loss in its 20th year. Note that another comparable project, the Eastern Harbour Tunnel, eliminated its loss in its 7th year.

Tolls constitute TCTC's core income and account for about 96% (2011/12) of TCTC's total revenue. The proposed toll increase as set out below is expected to generate additional revenue eventually to achieve a reasonable investment return.

Vehicle category	Current toll	Proposed toll	Increase amount
Motorcycle	\$12	\$13	\$1
Private car & taxi	\$15	\$17	\$2
Public light bus	\$21	\$23	\$2
Private light bus & light goods vehicle	\$22	\$24	\$2
Medium & heavy goods vehicle	\$26	\$28	\$2
Single-decker bus	\$29	\$31	\$2
Double-decker bus	\$32	\$34	\$2
Extra axle	\$19	\$21	\$2

Expected Effective Date

1 Jul 2013

Under the pressure of the accumulated shortfall in traffic revenue, much effort has been put into cost control. TCTC has reduced its operating costs (excluding rates and royalty paid to the Government) in every year over the past fifteen years; from about \$86 million in 1996/97 to about \$64 million in 2011/12. Even though TCT is the longest road tunnel in Hong Kong, TCTC's operating costs compare very favourably with other BOT tunnels. These cost reductions are not achieved through employee redundancy programs or by lowering service standards.

Traffic Implications

According to the latest forecasts, the toll increase currently proposed by TCTC would cause only slight traffic diversion to Lion Rock Tunnel (about 500 vehicles daily), Tai Po Road and Route 8 (less than 100 vehicles daily). Hence, there would not be significant traffic impact resulting from TCTC's currently proposed toll increase.

Service Performance

From TCTC's annual survey of customers' opinions, it is noted that over 96% of the surveyed customers considered TCTC's service satisfactory in recent years:

<u>Year</u>	<u>Percentage of customers who considered TCTC's service satisfactory</u>
2006	96%
2007	98%
2008	97%
2009	97%
2010	96%
2011	98%
2012	98%

Over recent years, TCTC has undertaken many initiatives to ensure smoother and safer traffic and higher reliability of service. Recent examples are:

- upgrading the manual toll collection system; and
- road resurfacing.

TCTC plans to invest more than \$14 million capital expenditure in the remaining 6 years to maintain various facilities and improve our services, such as upgrading the fire service installation, maintaining of interior tunnel wall and replacement of recovery vehicles.

Prepared by:

Tate's Cairn Tunnel Company Limited
April 2013

Implications of TCTC's Proposed Toll Increase

Financial Implications

If TCTC's application for toll increases is approved by Chief Executive-in-Council to take effect on 1 August 2013, the estimated royalty revenue to be paid to the Government in 2013/14 will increase by \$1.23 million from \$21.13 million to \$22.36 million.

Economic Implications

2. Given that tolls for using TCT constitute an insignificant proportion of average household spending, TCTC's proposed toll increases would have minimal effect on inflation.



本會檔號 Our Ref.

來函檔號 Your Ref.

19 April 2013

Professor the Honourable Anthony Cheung, GBS, JP
Secretary for Transport and Housing
22/F, East Wing
Central Government Offices
2 Tim Mei Avenue
Tamar
Hong Kong

Dear Professor Cheung,

**Application for Toll Increase
by Tate's Cairn Tunnel Company Limited**

The Transport Advisory Committee (TAC) has examined in detail the toll increase application submitted by the Tate's Cairn Tunnel Company Limited (TCTC) at its meeting on 26 February 2013. This letter sets out TAC's views on the application and its advice to the Chief Executive-in-Council.

TCTC submitted on 26 March 2012 an application for a toll increase at the Tate's Cairn Tunnel of \$3 for private car, and proportionate increases for other vehicle types, with effect from 1 July 2013. The proposed increase ranges from \$2 for motorcycle to \$6 for double-decker bus. The magnitude of toll increase ranges from 17% to 24%, with a weighted average rate of toll increase of 19.6%¹. Members noted that

¹ The weighted average rate of toll increase represents the percentage increase in total toll revenue calculated based on the proposed toll rates and the actual traffic of TCT.

TCTC has, upon the urging of the Administration, subsequently reduced the magnitude of toll increase and submitted on 8 November 2012 a revised application for a \$2 toll increase for all types of vehicles and additional axle except for motorcycle; and a \$1 toll increase for motorcycle. The percentage increase ranges from 6% for double-decker bus to 13% for private car, with a weighted average rate of toll increase of 11.1%.

TAC took all relevant factors and circumstances into account in considering the revised application, including the financial performance of TCTC, return on investment, traffic implications that might be brought about by the proposed toll increase, prevailing economic conditions, public acceptability and affordability. Its findings and views are summarized below.

Members noted the improvement in the financial performance of TCTC. Its bank loan and shareholders' loan have been repaid. It wiped off the accumulated loss by 2007/08, and had an accumulated profit of \$625 million at the end of 2010/11. When compared with the Eastern Harbour Crossing, a similar infrastructure project, which was commissioned around the same time, TCTC's financial position was substantially less favourable. TCTC attributed this situation largely to a lower-than-expected toll revenue over the years as a result of a number of factors, including increasing toll disparity between Lion Rock Tunnel and Tate's Cairn Tunnel, relocation of the airport, diversion effect due to a wider choice of transport modes and alternative route choices, as well as migration of manufacturing activities to the Mainland. Against this background, it is estimated that TCTC would achieve a nominal Internal Return of Return on equity after tax (IRR) of 6.61% over the 30-year franchise period if no toll increase is to be made before the end of the franchise. If the toll increase application is approved, the nominal IRR would be increased to 6.76%.

Members noted that in its franchise bid submitted in 1988, TCTC had made an assumption that the project, with a construction cost of about \$1,962 million, would generate a nominal IRR of 13.02% over the 30-year franchise period. The projected IRR of 13.02% was not an agreed figure but was the lowest target IRR amongst the four Build-Operate-Transfer tunnels in Hong Kong. Members considered that for such a large scale and long term infrastructure investment, an IRR of 6.76% under the current toll increase application would not be unreasonable.

From a traffic management perspective, Members noted that with the proposed toll increase, about 500 vehicles would be diverted to the Lion Rock Tunnel and fewer than 100 vehicles would be diverted to Tai Po Road and Route 8 between Cheung Sha Wan and Shatin per day. The traffic impact on the road system linking Shatin and Kowloon would unlikely be significant, and motorists and commuters have a choice of alternate routes as well as alternative transport modes.

When considering public acceptability and affordability, Members noted that the weighted average rate of toll increase being applied for was slightly lower than the cumulative change in the Composite Consumer Price Index since the last toll increase from 25 December 2010 up to end June 2013, which was estimated to be 11.3%. It was also lower than the change in the Median Monthly Household Income, which had increased by 15.3% from \$18,300 for the fourth quarter of 2010 to \$21,100 for same quarter of 2012.

Members were aware of the right of TCTC to resort to arbitration. Should the toll increase be considered generally justifiable, it would be desirable, where possible, for the two parties to reach an agreement on the toll increases rather than to incur public spending on legal costs in resolving such differences through arbitration.

After considering all the relevant factors, TAC is of the view that TCTC's current application for toll increase is not unreasonable and is justified. I should be grateful if you would convey TAC's advice to the Chief Executive-in-Council.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'L. Kwok'.

(Larry Kwok)

Chairman

Transport Advisory Committee