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Panel on Transport and
Panel on Financial Affairs

Minutes of joint meeting
held on Monday, 4 October 1999, at 10:45 am
in the Chamber of the Legislative Council Building

Members present : Members of the Panel on Transport

Hon Mrs Miriam LAU Kin-yee, JP (Chairman)
Hon LAU Kong-wah (Deputy Chairman)
Hon Edward HO Sing-tin, SBS, JP
*Hon Albert HO Chun-yan
Ir Dr Hon Raymond HO Chung-tai, JP
Hon LEE Wing-tat
Hon Mrs Selina CHOW LIANG Shuk-yee, JP
Hon CHAN Wing-chan
Hon CHAN Kam-lam
Hon Andrew WONG Wang-fat, JP
Hon LAU Chin-shek, JP
Hon Andrew CHENG Kar-foo
*Hon FUNG Chi-kin

Members of the Panel on Financial Affairs

Hon Ambrose LAU Hon-chuen, JP (Chairman)
Hon James TIEN Pei-chun, JP
Hon NG Leung-sing
Hon CHEUNG Man-kwong
Hon Ambrose CHEUNG Wing-sum, JP
Hon HUI Cheung-ching
Hon SIN Chung-kai
Hon Jasper TSANG Yok-sing, JP

Member attending : Hon CHAN Yuen-han

Members absent : Members of the Panel on Transport

Hon LEE Kai-ming, SBS, JP
Hon TAM Yiu-chung, GBS, JP
Dr Hon TANG Siu-tong, JP

Members of the Panel on Financial Affairs

Hon Eric LI Ka-cheung, JP (Deputy Chairman)
Hon Kenneth TING Woo-shou, JP
Hon David CHU Yu-lin
Hon Cyd HO Sau-lan
Hon Martin LEE Chu-ming, SC, JP
Dr Hon David LI Kwok-po, JP
Hon Margaret NG
Hon Ronald ARCULLI, JP
Hon James TO Kun-sun
Hon Bernard CHAN
Dr Hon Philip WONG Yu-hong
Hon Timothy FOK Tsun-ting, SBS, JP

* Also a member of the Panel on Financial Affairs

Public officers attending : Transport Bureau

Mr Nicholas NG, Secretary for Transport

Mr Kevin HO, Deputy Secretary for Transport (1)

Mr Thomas CHOW, Deputy Secretary for Transport (4)

Mr Roy TANG, Principal Assistant Secretary for Transport (3)

Finance Bureau

Miss Denise YUE, Secretary for the Treasury

Mr Martin GLASS, Deputy Secretary for the Treasury (2)

Attendance by invitation	**:**	MTR Corporation Mr Jack SO, Chairman Mr Clement KWOK, Finance Director Mr Phil GAFFNEY, Operations Director Mrs Miranda LEUNG, Corporate Relations Manager
Clerk in attendance	**:**	Ms LEUNG Siu-kum, Chief Assistant Secretary (1)2
Staff in attendance	**:**	Mr Andy LAU, Senior Assistant Secretary (1)6

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I Election of Chairman

Members agreed that the meeting should be chaired by Mrs Miriam LAU.

II Privatization of Mass Transit Railway Corporation
(Legislative Council Brief on Mass Transit Railway Bill (File Ref.: TBCR 1/1017/99))

2. At the invitation of the Chairman, the Secretary for Transport (S for T) briefed members on the benefits of privatization of the Mass Transit Railway Corporation (MTRC), and addressed some of the key concerns expressed by the community on the issue, particularly the fare determination mechanism and the length of the franchise period. The Secretary for the Treasury (S for Tsy) then briefed members on the financial aspects of the privatization, highlighting benefits the introduction of private ownership into MTRC would have on the Government, investors and Hong Kong as a whole. The Chairman of MTRC (C/MTRC) also explained the benefits of privatization from the Corporation's point of view and its commitment in supporting the continued development of railway infrastructure in Hong Kong. A copy each of the speaking note of S for T, S for Tsy and C/MTRC were attached in the Annex to the minutes.

Fare determination mechanism

3. Regarding the future fare determination mechanism for MTRC, Mr LEE Wing-tat opined that there was a need to strike a balance between safeguarding the interest of the public and maintaining a healthy financial performance of the Corporation. Given MTRC's average fare increase of 7.5% per annum since 1979, which was lower than

the average increase in Consumer Price Index (CPI) (A) of 8.2% during the same period, Mr LEE suggested that the increase rate should be capped at a fixed percentage in aggregate below general inflation over a certain period, say five or 10 years. Mr CHENG Kar-foo echoed Mr LEE's view and said that a similar fare determination mechanism had previously been applied to Hong Kong Telecom (HKT). The mechanism would remove any uncertainties among the general public and investors on future fare increases.

4. S for T advised that since the establishment of MTRC in 1975, the Corporation had been operating on prudent commercial principles and enjoying fare autonomy. The fact that MTRC's average fare increase had been lower than the average increase in CPI (A) during the same period whilst the Corporation could still manage to keep on improving its operational efficiency, expanding its network and enhancing its service quality did demonstrate that the present system had been working successfully and therefore had no need to change.

5. Commenting on the proposal of capping the fare increase, S for T said that unlike HKT which had a virtual monopoly, MTRC had been operating in a competitive environment. He further said that whilst the fare adjustment mechanism cited by Mr LEE Wing-tat could be found in some overseas utility industries, the operating environment there were totally different from that in Hong Kong. As to the former, substantial amount of Government subsidies were required in order to sustain the operation of the utilities whereas MTRC ran one of the most efficient and profitable railway system in the world. Given the circumstances, the Administration considered it more effective to use market force to regulate the fare of MTRC.

6. Mr LEE Wing-tat did not agree to the Administration's reply. He said that as the Administration believed the introduction of private ownership would reinforce MTRC's commitment to competitiveness and efficiency, there was no reason to believe that the Corporation would not be able to pitch the annual rate of increase at a level below inflation which they had managed to achieve in the past 20 years.

7. C/MTRC reiterated that there was a fundamental difference between MTRC and the overseas metro systems applying a fixed formula for fare adjustment. Besides involving a substantial Government subsidy in the operation of these overseas metro systems, the development of some of these systems had already reached an advanced stage and there was little room for further expansion. With such an operating environment and the availability of subsidy provided by the Government, there was no incentive for these overseas railway companies to initiate programme for improvement.

8. Regarding fare increase, C/MTRC said that MTRC had not raised its fares for two years due to the difficult economic conditions. He advised that in a Council debate over a Private Member's Bill two years ago, Members had thoroughly discussed whether a fare determination mechanism should be set up for MTRC. Ultimately, the Council decided to retain the existing system on fare determination as this would be in the best long-term interest of the Corporation as well as the commuting public.

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Under the system, the Corporation would still need to consult the Transport Advisory Committee (TAC) and the Legislative Council for fare increase. In addition, the Corporation had adhered to a self-imposed discipline of ensuring fare increases to remain below the rate of inflation over the years. C/MTRC further stressed that fare decisions had to also take into consideration of the severe competition posed by the various modes of transport.

9. Mr LAU Chin-shek expressed grave concern that the fare determination mechanism of the future privatized Corporation would not be subject to control of the legislature. He queried the reason for allowing the Corporation to deviate from the existing regulatory mechanism for other modes of public transport.

10. S for T replied that due to different historical reasons, the fare adjustment mechanism of different modes of public transport in Hong Kong varied. Given that MTRC had been running one of the most efficient and profitable railway systems in the world, the Government considered that the present system had been working well in the past 20 years and should not be changed. C/MTRC denied that MTR fares were free from control. He stressed that decisions on fare increase had to be approved by the Board of Directors appointed by the Government. The Corporation was also required to consult the TAC and the legislature and to report its decision to the Executive Council. Further, the Chief Executive had the power to give directions to the Corporation.

11. Mr LAU Chin-shek disagreed with the Administration that the existing mechanism was effective in controlling the fare adjustment of MTR. He was of the view that MTRC had been granted with an excessive power on fare determination. C/MTRC replied that a public opinion survey would be conducted by the Corporation prior to each year's fare adjustment exercise. Views expressed by the Legislative Council and other relevant parties would be duly considered by the Corporation. There had been cases in the past where amendments had been made to the Corporation's fare increase proposals, having regard to views expressed by the Legislative Council. Mr LAU Chin-shek requested the Corporation to provide further information on how the public views collected in relation to fare increase had been considered by the Corporation.

C/MTRC

Market Forces

12. Dr Raymond HO expressed concern about the Government transport policy of reducing reliance on road-based transport and the resulting implications on whether sufficient market force could be generated for the purpose of regulating the fares of MTR. Mr Andrew WONG also echoed Mr HO's view and pointed out that in the past, the Government had introduced measures to restrict the growth and penetration of bus service in the North-west Transit Service Area so as to facilitate the running of the light rail system serving Tuen Mun New Town and Yuen Long. As such, effective competition amongst different modes of public transport did not exist.

13. S for T said that due to road capacity constraints and having regard to the fact that railway was an effective carrier, the existing railway network would need to be expanded in order to meet the transport needs of commuters. By 2016, it was expected that more than 40% of all public transport journeys would be made on railway systems. Regarding the growth of other transport modes, S for T advised that there would be a steady growth in the number of passengers but the market shares in percentage would decrease with the expansion of new railway networks in the years ahead and the growth in population. In granting future development rights for new rail lines, the Government would take all relevant factors into consideration and would not seek to exempt any company from market competition.

14. As regards the concern over the promotion of the use of environmentally friendly and efficient mass carriers such as railway which might eventually alter the level playing field for competition, S for T advised that railway would form the backbone of the transport system in Hong Kong. However, other modes of public transport would still have an important role to play. In the course of the service delivery, there was a need to strike a proper balance having regard to the efficient use of the limited road spaces in Hong Kong and the need to provide adequate transport services to meet the demand of the commuting public.

Justification for Privatization

15. Members noted that one of the financial benefits of MTRC's privatization was that it could generate significant proceeds for the General Revenue, provide a useful boost to Government finance in the medium term and help reduce the budget deficits. Mr CHAN Kam-lam enquired whether the Government would continue to sell public assets to cover the budget deficits. He opined that he could not accept such a means to generate government income as it would be a clear sign of departure from the established public finance policy where the Government should follow the principle of keeping expenditure within the limits of revenues in drawing up the budget, and strive to achieve a fiscal balance, avoid deficits and keep the budget commensurate with the growth rate of the gross domestic product.

16. S for Tsy clarified that the primary objective of MTRC's privatization was not to generate proceeds for the General Revenue. Further, the Administration had no plan to further privatize other assets owned by the Government in full or in part in the near future. Regarding the general principles of public finance, she stressed that the Government would strictly follow the provisions as stipulated in the Basic Law.

17. On the proceeds generated from the initial public offering (IPO), S for Tsy advised that the Administration had worked out an estimate for the purpose of financial planning. Assuming that the proceeds from the IPO would reach $30 billion in the next two years, the expected revenue of $15 billion in 2000-01 would reduce the forecast budget deficit in that financial year to HK$5.6 billion. The other half of the revenue ($15 billion) in 2001-02 would even create a budget surplus. However, the exact timing of the IPO and percentage of shares to be listed would depend on market

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conditions.

18. On the calculation of the estimated short term capital income of $30 billion, Mr SIN Chung-kai enquired whether the proceeds from listing in one go would be financially more attractive than preserving MTRC as a Government wholly-owned Corporation and receiving dividends in long term.

19. S for Tsy replied that the principle of free market economy was well accepted by the Government and the general public at large. As such, if market participants were interested in the privatization exercise, the Government saw no reason why the IPO arrangement should be rejected. Regarding the proceeds from listing as opposed to the partial loss of dividends, S for Tsy advised that the Administration had not carried out a study in this regard. Indeed, it was impossible for the Administration to accurately assess the value of the MTRC at this stage as there were many factors which would influence the ultimate value of the Corporation and these factors were not very clear at the moment. On the justifications for listing, she clarified that the listing of MTRC was not primarily intended to generate income for the Government. There were other more important reasons for the privatization. For example, the listing of a high quality, heavily capitalized company like MTRC would add stability and diversity to the Hong Kong stock market. A high-profile and successful public offering would help buttress Hong Kong's status as an international financial centres. It was also a practical demonstration of the Government's commitment to a free market economy.

20. Regarding the financing channels, S for Tsy advised that after privatization, the MTRC would have more access to capital and financing channels including the issuance of new shares. This could reduce the amount of government funds for investment in the Corporation. The Government funds could then be re-directed to other projects. Furthermore, essential works by the MTRC would not be delayed due to the Government's financial considerations.

21. Noting that MTRC had already been one of the most efficient railway systems in the world, Mr SIN Chung-kai enquired whether there was still room for improvement in the system which justified a privatization proposal. C/MTRC advised that the primary objective of the Corporation was to provide a better service at a lower cost. With closer monitoring from investors, he trusted the privatized Corporation could further enhance its efficiency and productivity after privatization.

Listing Plans

22. Whilst indicating his support to the privatization of MTRC, Mr James TIEN enquired whether consideration would be given to allowing MTRC to issue new shares rather than privatizing a substantial minority share of MTRC under the present proposal. He considered that the issuance of new shares could allow the Corporation to finance future projects, to reduce interest payment, and to relieve pressure on staff cut and future fare increases.

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23. S for Tsy advised that at present, the only project undertaken by the MTRC was the Tsueng Kwan O Extension and the arrangements for the financing of the project has been fully completed. As regards other on-going improvement works, she confirmed that adequate funds had been made available for the projects. In view of the circumstances, the Administration did not see a need for the Corporation to retain the proceeds from the listing. Referring to MTRC's capability to solicit funds in the capital market, she advised that at present, the credit rating of MTRC was identical to the sovereign rating of the Government. After privatization, the MTRC would have even more access to capital and financing channels.

24. Explaining the importance of the need for the Government to remain as the largest shareholder for the foreseeable future, S for Tsy advised that a continuing government shareholding would be reassuring to the commuting public of Government's commitment to Hong Kong's transport sector. In addition, it would be a positive sign to demonstrate to both investors and credit rating agencies the Government's commitment to future railway development in Hong Kong. S for Tsy further advised that similar to other shareholders, the Government would bear the prospects and burdens incurred by the privatized Corporation.

Property Development Rights

25. Mr CHEUNG Man-kwong and Mr HO Chun-yan expressed grave concern that the Government would continue to grant property development rights on top of stations and depots to the future privatized Corporation. They considered such a grant a kind of preferential treatment since the privatized Corporation was no longer a Government wholly-owned Corporation as it was the case in the past. As such, it was inappropriate for the Government to utilize public monies to subsidize private investment.

26. S for T replied that in the event that public interest and transport policy required MTRC to develop commercially unviable rail projects on social and economic grounds, Government was prepared to bridge the gap and might grant property development rights on top of stations and depots to MTRC so that these projects could provide a commercial return. This arrangement had all along been adopted by the Government. In so doing, MTRC was required to pay the full premium of the land so granted.

27. Mr CEHUNG Man-kwong responded that the issue at stake was not related to the premium of the land but the granting of property development rights to a private company without going through a normal tendering process. In his view, this arrangement was unfair to other market players and was simply a replica of the Cyberport project.

28. C/MTRC responded that MTRC had played a significant role in the property development on top of its railway stations and had established new communities along the railway footprint. MTRC should therefore be allowed to continue its role in integrating railway and property developments.

Conflicting interests amongst different parties

29. Mr CHEUNG Wing-sum expressed concern over the conflicting roles played by the Government and how conflicting interests amongst different parties, including small investors, major shareholders, the Government and the public could be resolved. He said that in the absence of a clear policy as to whether the Government would remain as a majority shareholder of the privatized Corporation throughout the entire franchise period, he worried that any subsequent changes to Government's holding of the shares in the privatized Corporation might give rise to litigation from small investors against the Government. Likewise, objections from small investors would arise if there was a public demand for changing the existing policy of granting property development rights to the privatized Corporation in future.

30. S for T reiterated that the present proposal sought to maintain the status quo. The only change involved in the exercise was to privatize a substantial minority share of MTRC through an IPO. Regarding the length of the franchise, he said that the Government would consider extending the franchise period of the privatized Corporation, taking into account its railway development plans. As regards the conflicting roles played by the Government, he said that similar situation existed at present and the Government was able to resolve the conflicts and provide an effective and efficient rail systems to the commuting public. In future, the privatized Corporation would be required to meet a number of stringent but objectively defined performance levels. Regarding the interests of small investors, he advised that they could elect their own representatives to the Board of Directors to protect their interests.

Quality of Service

31. Mr CHAN Wing-chan expressed concern about the performance levels and safety of the railway system after privatization. He questioned whether there would still be sufficient manpower to upkeep the performance levels and undertake the related maintenance and repair work after the implementation of the Voluntarily Separation Scheme.

32. C/MTRC advised that the Corporation had all along been running under prudent commercial principles. As such, the implementation of the Voluntarily Separation Scheme should not be linked with the privatization exercise. He further advised that after privatization, the employment terms and condition of services for existing staff would remain unchanged. Regarding the quality of service, he said that the Operating Agreement would stipulate even more stringent standards for compliance by the future privatized Corporation.

New Rail Projects

33. Noting that the Government would continue to play a major role in awarding new rail projects to a partially privatized MTRC and the Kowloon-Canton Railway

Corporation (KCRC) which would remain 100 percent Government-owned, Mr HUI Cheung-ching enquired whether these two companies would be treated differently by the Government and whether it had any plan to privatize KCRC to ensure a level playing field in the market. S for T replied that the Government would treat the two companies in a fair manner. He added that the Government did not have any plans to privatise KCRC at this stage.

Independent body to examine fare increase

34. Mr HO Chun-yan pointed out that when the former S for T, Mr Gordon SIU, spoke on the Mass Transit Railway Corporation (Amendment) Bill 1996, he undertook to consider establishing an independent committee to examine fare increase applications from all public transport operators. He regretted that the Administration had failed to introduce such a regulatory system.

35. S for T said that the Administration had conducted a thorough review as agreed and submitted two detailed information papers, setting out the result of the Administration's views on the setting up an independent committee to examine fare increase applications from all public transport operators. He asked members to refer to the papers for details.

> (*Post meeting note* : The information papers referred to by S for T were subsequently circulated to members vide LC Paper No. CB(1) 33/99-00).

Business Scope of the Future Privatized Corporation

36. In response to Mr Raymond HO, S for T said that the core business of the privatized Corporation would remain unchanged. In fact, the Memorandum of the Corporation would clearly stipulate the scope of business of the Corporation. However, some degree of flexibility should be allowed for the running of other business within the railway premises.

Article 123 of the Basic Law

37. As regards the land grant to the new Corporation, Mr NG Leung-sing enquired whether there were cases where the original leases granted to the MTRC for the running of the MTR network, which contained no right of renewal, would expire before 30 June 2047. In response, S for T advised that normally, the land granted to the MTRC for the development of MTR network was made in accordance with the provisions of the Basic Law.

38. The Chairman advised that she would suggest a Bills Committee be formed to examine the Bill when it was introduced into the Council. The concerns raised by members at the meeting would be further deliberated by the Bills Committee.

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III Any other business

39. There being no other business, the meeting ended at 12:50 pm.

Legislative Council Secretariat
7 December 1999

Annex

Privatization of Mass Transit Railway Corporation
Joint LegCo Panels on Transport and Financial Affairs

SPEAKING NOTE FOR

SECRETARY FOR TRANSPORT

Chairman,

Introduction

- In his Budget Speech on 3 March 1999, the Financial Secretary announced a plan to privatize a substantial minority share of the Mass Transit Railway Corporation (MTRC). The Government has since worked closely with MTRC and our financial consultants to take the project forward.

- The Mass Transit Railway Bill was gazetted on 24 September 1999. We will introduce the Bill into the Legislative Council on 13 October 1999. Today, I am glad to have this opportunity to discuss with Members the details of the Bill and the privatization plan.

- I will first speak on the benefits that the privatization exercise will bring to the community and public in general. I will also address some of the key concerns expressed by Members and the community about the privatization of MTRC, including the fare determination mechanism and the length of the franchise period.

- Secretary for the Treasury, Ms Denise Yue, will later explain to Members the impacts of privatization of MTRC on Government finance and Hong Kong's financial market.

- Mr Jack So, Chairman of MTRC, will also explain the benefits of the privatization from the Corporation's point of view.

Benefits of Privatization of MTRC

- The privatization of MTRC will bring the following benefits to the community:

  (a) Introduction of private ownership will bring strengthened market discipline to the Corporation, promoting even greater levels of efficiency.

  (b) Privatization will broaden MTRC's access to sources of capital and financing alternatives. This will help the expansion of railway network and the improvement of railway services.

  (c) Privatization of MTRC will also provide an attractive opportunity for the people of Hong Kong to invest in a solid, well-managed company with strong growth potential.

<u>MTRC's Fare</u>

(A) <u>Fare Autonomy</u>

- After we published the MTRC privatization proposal, both Members and the media expressed concern on the fare determination mechanism of the future privatized Corporation. Some suggested that the Government should change the existing mechanism and allow LegCo or other external authorities to approve MTRC's fare.

- Firstly, we must point out that since the establishment of MTRC in 1975, the Corporation has been operating according to prudent commercial principles and enjoying fare autonomy. It is a matter of fact that MTRC's average fare increase has been 7.5% per annum since 1979, lower than the average increase in Consumer Price Index (A) of 8.2% during the same period.

- Even though the average fare increase is lower than inflation, MTRC still manages to keep on improving its operational efficiency, expanding its network and enhancing its service quality. We believe that the present system has been working successfully and there is no need to change.

- In fact, the Legislative Council also studied and discussed in details on whether the existing MTRC fare determination mechanism should be changed. In February 1997, a delegation of LegCo Members was formed to study overseas metro systems. The report published by the delegation provides us a clear message. The report points out that:

(a) "direct involvement of legislature in the fare setting process and the right to endorse or veto fare adjustment is not common" (paragraph 3.10 of the Report); and

(b) "there is no evidence to suggest that a Government or Parliament-driven fare determination mechanism will necessarily result in lower subsidy with tax payers' money or lower fares for commuters" (paragraph 3.12 of the Report).

- The Government believes that we should not change the present system which has been working well in the past 20 years.

(B) <u>Market Force</u>

- MTRC is already subject to fierce competition from other public transport providers. We believe market competition provides the best form of fare regulation. Some critics suggested that MTRC's fare was generally higher than bus and this indicated that market competition did not function properly. I do not agree with such argument because:

(a) Roughly speaking, MTRC's fare is about 15% to 20% higher than bus. However, MTRC offers its customers faster, more reliable and more comfortable services. The difference in fare reflects the difference in the functions and efficiency of different transport modes.

(b) I can also use statistics to demonstrate the effects of market force. In the past few years, with the opening of new roads and improvement of bus services, the overall market share of MTRC decreased from 26.7% in 1996 to 25.7% in 1998. Over the same period, its share of the cross harbour market has also experienced decline from 66.5% to 61.9%.

(c) Some critics pointed out that MTRC was operating in a monopolistic market and the use of market force to regulate its fare would not be effective. However, past statistics also indicate that the above argument is not true. In the past 20 years, MTRC, although operating an extensive railway network in Kowloon and Hong Kong, has not been able to surpass Kowloon Motor Bus in terms of passenger volumes. MTRC is, therefore, not operating in a monopolistic market.

(C) <u>Consultation</u>

- After privatization, MTRC will need to consult the LegCo Panel on Transport and the Transport Advisory Committee before adjusting its fares. Such arrangement will be stipulated in the Operating Agreement, which is a legally binding document signed by the Government and MTRC. This will ensure that when determining its fare, MTRC will be required to fully consider public acceptability.

<u>50 Years Franchise</u>

- Regarding the terms of the franchise, the Bill provides that:

  (a) It will grant a 50 years franchise to the new company to operate and maintain the MTR system.

  (b) In future, if MTRC is awarded to construct a new railway project, or implements projects which required the Corporation to invest over a certain level of capital, the Corporation will be eligible to apply to the Government for an extension of the franchise for a full 50 years term.

- I read from the newspapers that some critics considered the 50 years franchise was too long when compared with the franchise periods of other franchise operations granted by the Government.

- Firstly, I have to point out that the suggested franchise period is in line with the Government's practice in awarding railway projects to MTRC in the past 25 years.

- Since the commencement of MTRC's operation, the Government has granted the Corporation 50 years land leases to build new lines. For example, the Tung Chung Line, the Airport Express Line and the Tseung Kwan O Extension are all granted 50 years land leases.

- A 50 years franchise is considered appropriate. The base period the Corporation used to calculate the Internal Rate of Return for MTR projects is 40 years from commissioning. In addition, design and construction of railway projects usually take 10 years.

- The Government's proposal is also in line with overseas privatization experience. As a general rule, the length of franchises in overseas privatization exercises depend on whether the franchisees are required to provide both passenger services and railway infrastructures (e.g. rail tracks, stations, etc). If the franchisee is only required to operate passenger services, the franchise period is generally shorter than 10 years. But if the franchisee is also required to provide railway infrastructures, the franchisee will need to invest substantially into the railway system and a perpetual franchise period is usually granted. Since the MTRC is responsible to provide both passenger services and railway infrastructures, a longer pay-back period is therefore required. We believe that a 50 years franchise, couple with a transparent franchise extension mechanism, is appropriate.

- If the franchise period is to be shortened, fare must need to be raisen in order for the Corporation to maintain the same level of internal rate of return. We believe that both the general public and Members do not wish to see a higher MTRC fare.

Regulatory Framework

- Some members of the public worried that if MTRC was granted a 50 years franchise, the Corporation would have no incentive to improve its service quality. The Government has included in the Bill a number of measures to safeguard the interest of the public, including:

(a) Firstly, the Operating Agreement, which is the franchisee document to be signed by the Government and MTRC, will require the Corporation to meet a number of stringent, but objectively defined performance levels. If the Corporation fails to meet these performance levels, the Bill empowers the Government to introduce sanctions to the Corporation, including financial penalty, and suspension or even revocation of franchise. This new, transparent regulatory mechanism is certainly an improvement of the existing arrangement. It can effectively ensure that the public can continue enjoy high quality MTR services.

(b) In addition, MTRC cannot solely rely on incurring new capital expenditures to automatically extend its franchise. When considering MTRC's franchise extension application, apart from the level of new investments the Corporation commits to make, the Bill also requires the Government to consider whether MTRC is capable of providing an appropriate and effective railway service.

(c) Thirdly, when Government considers MTRC's new capital investments, we will take into account not only the investments made in new railway projects, but also the medium to long term capital expenditures the Corporation incurred to improve its services. This will provide the Corporation enough incentive to invest in improving its services.

<u>Conclusion</u>

- In conclusion, MTRC has performed well in the past 20 years because of:

(a) the Corporation operated according to prudent commercial principles;

(b) the Corporation enjoyed fare autonomy; and

(c) when determining its fares, the Corporation thoroughly considered public acceptability, and also consulted LegCo Panel on Transport and Transport Advisory Committee.

- The above three principles are the keys to the success of the MTRC's operation. The Government believes that we should not depart from these principles which have served the Corporation and the community well.

For 4 October 1999

Joint LegCo Panels on Transport and Financial Affairs
Privatisation of Mass Transit Railway Corporation
SPEAKING NOTE FOR
SECRETARY FOR THE TREASURY

1. Introduction

- Good morning, Chairman and Panel Members. I am pleased to be here today to say a few words on the financial aspects of the privatisation.

- The introduction of private ownership into MTRC will have positive effects on Hong Kong, its Government and investors.

2. Financial Benefits of MTRC's Privatisation

Hong Kong

Hong Kong's economy in general will benefit greatly.

- Smooth implementation of MTRC's privatisation plan will reinforce the importance of Hong Kong's status as an international financial centre.

- The addition of a well-capitalised, well-managed company such as MTRC would enhance the stability and diversity of the Hong Kong stock market.

- Privatisation, in and of itself, reinforces our commitment to a free market system.

- In the long run, successful privatisation of MTRC will provide a precedent for the possible privatisation of other public enterprises.

- Experience shows that the privatisation of a company generally brings about improved efficiency and productivity which will have positive impacts on the economic development of Hong Kong.

Government

- After privatisation, the MTRC will have more access to capital and financing channels. This will free up government funds for investment in the Corporation and re-direct them to other projects and help us to avoid budget deficits. Essential works by the MTRC will also not be delayed due to the Government's financial considerations.

- MTRC's privatisation should generate significant proceeds for the General Revenue and provide a useful boost to Government finance in the medium term. This will help reduce our budget deficit.

Investors

Investors will directly benefit from this opportunity to buy into a successful company.

- The offering would provide an attractive opportunity for local and international investors alike to participate in the success of a solid, well-managed company with a long history of profitable performance and good growth prospects.

3. Listing Plans

Government Shareholding

- It is the Government's intention to remain as the largest shareholder for the foreseeable future. In other words, the Government will hold not less than 51% of the share and continue to share in the prospects of the MTRC. We believe that a continuing government shareholding will be reassuring to the commuting public of our commitment to Hong Kong's transport sector. In addition, our continued role will demonstrate our commitment and support to both investors and credit rating agencies.

- This commitment will achieve the dual objective of enabling private investment in an outstanding Hong Kong based business, including the opportunity to share in future capital expansion, and retaining for Government an ongoing quality investment.

Initial Public Offering

- We intend to privatise a substantial minority stake in MTRC through an initial public offering.

- Assuming that the proceeds from the IPO would reach $30 billion in the next two years, the expected revenue of $15 billion in 2000-01 would reduce the forecast budget deficit in that financial year to HK$5.6 billion. The other half of the revenue ($15 billion) in 2001-02 would even create a budget surplus. This would help our finances get back on a healthy footing and return to fiscal balance sooner.

- The exact timing of the IPO and percentage of shares to be listed will depend on market conditions. The Government is still studying it and will make a determination based on the market situation.

4. *Valuation*

- There has been much speculation in the press about the potential value of MTRC and as always in such matters there is more than one view. It is premature to make any conclusions at this point. There are many factors which will influence the ultimate value of the Corporation and these factors are not very clear at the moment.

- We are reviewing these issues in preparation for the listing of MTRC and you should be aware that we expect them to have a positive impact on value. For example:

    ➢ It is Government's policy to place priority on rail as the backbone of the passenger transport system. Our approach on transport policy will reflect this. More explicit policies will be known with the release of CTS3 shortly and after the announcement of the findings of RDS2.

    ➢ Government has been supportive to the MTRC through several means, including land policy and funding. We see no reason to change this policy in supporting the continued development of railway infrastructure in the region, whilst ensuring projects are delivering commercial returns to the operators.

- As a shareholder with a vested interest in preserving value, Government can continue to support the MTRC through other means consistent with transport goals and policy.

5. *Closing remarks*

- In closing, we emphasise that this opportunity for the transition of MTRC to partial private ownership provides the opportunity not only to generate proceeds for the Government, but would also be enormously beneficial to Hong Kong both from a financial and policy perspective.

- The IPO of MTRC can be showcased as an affirmation of the Government's commitment to a free market economy. It will also give Hong Kong people who make 2.3 million trips on the MTR daily an opportunity to participate as part-owner of the MTRC.

Speaking Notes of Mr Jack C K So, Chairman of MTR Corporation, at the Joint Meeting of Legco Panel on Transport and Financial Affairs on 4 October 1999

Chairman, Honourable members, Ladies and Gentlemen,

I wish to thank you for the opportunity to share the Corporation's views on the government's plan to list a substantial minority interest of the MTR on the Stock Exchange of Hong Kong.

BACKGROUND

Just last Friday, the MTR celebrated its 20th birthday. For 20 years, the MTR has diligently served Hong Kong's travelling public with what has been recognised around the world as a first class railway service.

Twenty years ago, we were still learning how to operate a railway from our counterparts in Europe and North America. Today, other railway operators from around the world are looking to learn from us and copy our successful formula for running one of the safest, most reliable, convenient and comfortable systems in the world.

Over the last two decades, the MTR has changed the way people live and work in Hong Kong. We have cut down intra-city travel time and built new communities along our extensive route network. In a very significant way, MTR has contributed to the modern day Hong Kong.

In a debate over a Private Member's Bill in this Council two years ago during which the fare setting mechanism of MTR was thoroughly examined; international comparisons were scrutinised; Members went on study trips abroad; and overseas witnesses were called to give evidence. Ultimately, the Council decided to retain the existing system of fare determination as this is in the best long-term interest of the Corporation as well as the travelling public. Such a system does subject the Corporation's fare decisions to consultations with TAC and LegCo. In addition, the Corporation has adhered to a self-imposed discipline of ensuring fare increases remain below the rate of inflation over the years. Last but not least, fare decisions must take into consideration the severe competition posed by buses and other forms of public transport.

However, such a system has given the Corporation certainty over future income streams which greatly facilitate its funding and enable the Corporation to undertake all the necessary maintenance, upgrading as well as expansion projects. This is the secret of MTR's success. This is what distinguishes us from the less successful systems around the world.

BENEFITS OF PRIVATISATION

As a transportation backbone, the MTR is a strategic asset to Hong Kong. It seems fitting that as we head into our next 20 years of operation, the people of Hong Kong are given the unprecedented opportunity to participate in this valuable asset through the purchase of MTR shares. We want all our passengers to have an ownership interest in the system which 2.3 million of them ride every day.

Interest in the MTR extends beyond the local investor community. MTR already has a high profile in the international financial markets as one of Asia's leading bond issuers and the privatisation plan is being followed closely by the international investment community.

We have already established an excellent international reputation for efficiency and quality of service. Listing the MTR will allow the government to showcase to international investors a world class corporation.

Again confirming the spirit of free enterprise is alive and well in Hong Kong while the size of the public sector is reduced. The proceeds from the listing will go into Government coffers to fund capital projects and public expenditure. As MTR is the first test case, a successful listing will pave the way for other Government assets to become public companies.

As a high quality, capitalised company, the MTR will add diversity and stability to the Hong Kong stock market and bolster the SAR's status as an international financial centre. Hong Kong's reputation for having a free market economy with a strong private sector will be enhanced.

For the Corporation, privatisation will provide an additional source of financing through equity. It will reduce our reliance on capital injection from the government when building new extensions. It would give us a choice to borrow less from financial markets, allowing us to manage the size of our interest payments.

An added flexibility to undertake other commercial businesses will give us new sources of revenue and enhance returns. Together, these factors will work to reduce future pressure on fare increase and to maintain our top class operating service standards at a reasonable, good value for money fare which can only be good news for our customers.

Privatisation will also bring new opportunities to staff of the Corporation. As the MTR enjoys greater freedom to expand and diversify its business, our staff will benefit from the new opportunities created to develop and grow professionally. The MTR is able to operate efficiently and effectively because of its hard working and dedicated workforce. They are one of the MTR's greatest assets and will continue to contribute to the continuous success of the Corporation. We will seek to encourage widespread staff ownership of shares so that they can benefit from the continued success of the Corporation.

FRAMEWORK

However, we must not take it for granted that investors will buy MTR shares with their eyes closed. The initial public offering will be a huge and challenging exercise.

Investors recognise that railway investment involves large upfront capital investments requiring a very long investment payback period. They need to have a high level of confidence that the regulatory structure is strong enough to protect their investment or lending throughout this very long period.

In this process, we must also remember that MTR already has over HK$30 billion of outstanding bonds and bank lines and we need to protect the interests of these investors and lenders through preserving the Corporation's credit ratings.

We believe that the existing process of setting fares after consultation has given Hong Kong the best of both worlds: on the one hand providing affordable fares to passengers and on the other hand, enabling external funding to be raised to develop our world class railway system. It is important to leave this fare setting process unchanged to maximise the value of the Corporation and to uphold our existing position as Asia's best credit.

CONCLUSION

The MTR is committed to continue playing a key role in building and contributing to the important infrastructure growth of Hong Kong. Privatistion will enhance our commercial principles and facilitate the development of rail transport to cater for the transport needs of Hong Kong into the 21st century.