Legislative Council Panels on Transport and Financial Affairs

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

Purpose

Annex A The Government has reached an understanding with MTR Corporation Limited (MTRCL) on the structure and the terms, as summarised at **Annex A**, for the proposed merger of the MTR and Kowloon-Canton Railway (KCR) systems. The Government has entered into a non-binding Memorandum of Understanding (MOU) with MTRCL on this basis. This paper seeks Members' views on the Government proceeding with the rail merger on the basis of the proposed merger package.

Background

2. In February 2004, the Government invited the MTRCL and Kowloon-Canton Railway Corporation (KCRC) to commence discussion on a possible rail merger on the basis of the following parameters -

(a) adoption of a more objective and transparent fare adjustment mechanism (FAM);

(b) abolition of the second boarding charge and review of the fare structure with the objective of reducing fares;

(c) early resolution of interchange arrangements for new rail projects under planning, notably the Shatin to Central Link (SCL);

(d) ensuring job security for frontline staff at the time of merger; and

(e) provision of seamless interchange arrangements in the long run.

Outcome of Merger Discussions between MTRCL and KCRC

3. MTRCL and KCRC completed their discussions on a possible merger in September 2004. The outcome of the merger discussions indicates that a merger of the MTR and KCR systems is feasible and the five parameters set by the Government for the merger discussions can be addressed positively. After further discussions between MTRCL and the Government over the transaction terms for the rail merger, MTRCL has put forward a package of proposals for meeting the five parameters.

Proposal by MTRCL

Compliance with the five parameters

4. MTRCL's proposal is explained and assessed in detail in paragraphs 5 to 17 below. The proposal has met the five parameters and will provide significant benefits to the general public.

<u>*Parameter 1: Adoption of a more objective and transparent fare adjustment mechanism (FAM)*</u>

5. 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, prevailing market conditions, competition from other transport modes and the corporations' financial objectives. In the context of the rail merger exercise, the Government has proposed the introduction of an FAM that could address -

(a) the public concern that the process for adjustment of transport fares should be more objective and transparent and should allow for reduction as well as increase in fares;

(b) the concern of public transport operators that once fares are reduced, public pressure will render fare increases difficult if not impossible, even when the economy is improving; and

(c) the common concern of public transport operators and the Government that fare adjustments should not be politicised as it is not conducive to efficiency and social harmony.

6. Against this background, MTRCL and KCRC have proposed a formulaic approach for determining future fare adjustments to replace fare autonomy after the rail merger. After further detailed discussions between MTRCL and the Government, MTRCL's proposal is that the FAM should be based on the following formula -

Overall fare adjustment rate =

$$0.5 * \Delta CCPI + 0.5 * \Delta \text{Wage Index} - \text{Productivity Factor},$$

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.

7. A formula having regard to changes in the CCPI and the wage index would improve transparency as future fare adjustments would be determined based on published indices, and it would improve objectivity as the formula adopts well-established indices which are objective and verifiable. The FAM would allow both downward and upward adjustment of fares according to the formula.

8. The formula includes a productivity factor which would allow passengers to share the benefits of productivity gain of the post-merger corporation (MergeCo). 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, taking into account that MergeCo would be returning the productivity benefits to passengers by way of a fare reduction immediately upon the rail merger before it could fully realise the benefits of the synergies identified, and the scope for productivity gain is limited due to heavy investment particularly as the railway network is expanding.

9. Fares would be assessed and adjusted on an annual basis under the proposed FAM. 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.

10. The proposed FAM[1] would be subject to a review every five years upon request by either the Government or MergeCo.

Parameter 2: Abolition of second boarding charge and review of the fare structure with the objective of reducing fares

11. The present MTR and KCR networks are operated as separate systems. A combined railway network would achieve some degree of economies of scale and facilitate the abolition of second boarding charge. Nevertheless, it should be noted that the abolition of second boarding charge or any general fare reduction would impact adversely on fare revenue of MergeCo in the long run.

12. According to the joint assessment of MTRCL and KCRC, synergies could be realised from both revenue and operating costs, with the former mainly achieved through the broadening of the sales and distribution network and from railway/station-related businesses such as advertising, and the latter principally through the achievement of economies of scale in railway operation over time. The two corporations have reviewed their existing fare structures with a view to rationalising the fare levels for MergeCo in the light of the potential synergies arising from the rail merger, and they proposed a fare reduction comprising abolition of second boarding charge, global fare reduction for all Octopus card users paying full fares and additional fare reduction for selected journeys.

13. After further discussions between MTRCL and the Government, MTRCL has proposed the following fare reduction package -

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

[1] The FAM would apply to all existing MTR and KCR services and new railway lines which are natural extensions of the MTR and KCR railways, with the exception of Airport Express Line (AEL), Tung Chung Cable Car, and intercity services.

(b) further global fare reduction of \$0.20 for all Octopus card users paying full fares[2];

(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[3]; 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[4];

Under this fare reduction package, there would be a minimum of a 10% fare reduction for all passengers travelling on journeys with fares at \$12 or above and a minimum of 5% fare reduction for all passengers travelling on journeys with fares between \$8.50 and \$11.90. Taking into account the benefits from abolition of second boarding charge and the global fare reduction, altogether 2.8 million daily rail trips[5] will benefit from fare reduction on Day One of the rail merger. About 340,000 of them would benefit from a minimum of a 10% fare reduction and another 1.16 million would benefit from a minimum of a 5% fare reduction. This fare reduction would encourage employment, as cross-district travelling to work would become cheaper, and would complement the Government's other efforts to encourage employment.

14. There will be no fare increase for the next 24 months following the signing of the MoU. MergeCo would also provide a concessionary fare of \$2 per trip in the first year after the rail merger for senior citizens

[2] The global fare reduction will be reduced by the corresponding concessionary rates for specific passenger categories enjoying concession, e.g. \$0.1 for children as they enjoy 50% concessionary fares.

[3] For Single Journey Tickets, this would subject to the rounding of the fares.

[4] For Single Journey Tickets, this would subject to the rounding of the fares.

[5] The proposed fare reduction would apply to all domestic MTR and KCR railway lines. There would be no change to the fares of the AEL and the Lo Wu and Light Rail services because of the rail merger.

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 the MTR.

Parameter 3: Early resolution of interchange arrangement for new rail projects under planning, notably the Shatin to Central Link (SCL)

15. The SCL is a committed, new railway project in the pipeline for implementation. The project was awarded to KCRC in 2002 after a competitive bidding exercise. In response to Government's request, the two corporations have examined in detail, during their discussions on the possible rail merger, the interchange arrangement for the SCL. The proposed SCL scheme in the context of the rail merger would provide for fully integrated interchange stations and interchanging passengers would not be required to pay any second boarding charge. We will further discuss with MTRCL on the funding and implementation details of the SCL.

Parameter 4: Ensuring job security for frontline staff at the time of the rail merger

16. MergeCo shall provide job security to all frontline staff as it relates to merger. The two corporations have agreed on a definition of frontline staff[6] for the purpose of the rail merger and they would explain the details to their staff. Further details about the plan for human resource integration are explained in paragraphs 36 to 39.

Parameter 5: Provision of seamless interchange arrangements in the long run

17. The integration of the operation of the two railway systems would improve passenger convenience and reduce journey time. Within the first year after the rail merger, ticket gates in the three existing interchange stations (viz. Kowloon Tong, Nam Cheong and Mei Foo

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[6] As agreed between MTRCL and KCRC, frontline staff means "those full-time non-managerial staff who are employed regularly and directly in the operations and maintenance of trains, stations, buses and vehicles; infrastructure maintenance; stores operations and security operations. Non-managerial staff refer to staff below Grade MG1 in the case of MTR and staff below Grade 8 in the case of KCRC, who are employed on either continuous terms or contract terms for a duration of two years or more."

Stations) would be removed and the interchange arrangements would be improved. These planned changes would involve restructuring the stations concerned to improve the passenger flow.

Proposed transaction structure

18. MTRCL's listing status would be maintained and it would be the legal entity of the future MergeCo. MTRCL would be granted a service concession by KCRC to make use of the latter's assets to operate the existing and new KCR railway lines under construction including the Lok Ma Chau Spur Line and the Kowloon Southern Link (KSL), as well as KCRC's other transport-related businesses such as bus operation in the North-west Transit Service Area. Under a service concession arrangement, a government/public body which is the grantor of the concession (KCRC in this case) enters into contractual arrangements to convey a right to the concession operator (MTRCL under the proposed deal) to provide specified services to the public.

19. Under the service concession agreement, MTRCL would be granted the right to use certain KCRC assets and railway land to operate the KCR system. MergeCo would be responsible for the operation, maintenance and improvement of the KCR system, including the replacement of the concession assets, during the concession period. It would exercise control over all the operational arrangements of the two networks as an integrated whole and be responsible for the performance of the total system. Upon expiry or termination of the service concession, MergeCo would be required to return an operating KCR system to KCRC that meets the prevailing operating standards. Under the service concession arrangement, KCRC would not be disposing of the railway system to MTRCL, and MTRCL would not be acquiring KCRC assets (except for certain low value items such as spare parts and consumables).

20. The service concession would be coterminous with the franchise of MergeCo with an initial term of 50 years. Under the merger proposal, that KCRC would retain legal title to the assets covered in the service concession, although Government will discuss further with

MTRCL the latter's wish to have the legal title to certain replacement and improvement assets, provided that these are returned to KCRC together with the initial assets upon expiry or termination of the service concession. Further, KCRC would continue to retain certain assets such as cash, receivables, shareholding in Octopus etc. and some $19.7 billion of debt.

21. In addition, KCRC would retain the obligations for their cross-border leases (CBLs) covering rolling stock and related hardware, such as signalling systems. MTRCL will co-operate with Government and KCRC to assist KCRC in meeting the obligations in respect of the CBLs provided that MTRCL receives protection from Government and KCRC in a form satisfactory to the Corporation so that MTRCL shall be in no worse a position as a result of such co-operation. In this regard, Government may consider the need to provide indemnity to MTRCL.

22. Apart from the service concession arrangement, MTRCL has proposed to acquire property-related interests of KCRC as well as the development rights for the property sites on KSL and the other commercial interests of KCRC as part of the deal. Details of the property package for the proposed rail merger are explained in paragraphs 23(d) and paragraphs 28 - 30 below.

Proposed financial terms

23. The financial terms proposed by MTRCL for the rail merger are as follows -

(a) an upfront payment of $4.25 billion for the service concession and for acquisition of certain short-lived railway assets of KCRC such as stores and spares;

(b) fixed annual payments of $750 million for the duration of the service concession;

(c) starting from the fourth year of the service concession, an annual share of the actual revenue generated from the KCR system based on a pre-agreed set of sharing ratios. The sharing ratios are –

(i) 10% for revenue exceeding \$2.5 billion and up to \$5 billion;

(ii) 15% for revenue between \$5 billion and \$7.5 billion;

(iii) 35% for revenue beyond \$7.5 billion; and

(d) a payment of \$7.79 billion for the acquisition of property and other related commercial interests. Separately, MTRCL will reimburse KCRC for enabling works costs already paid for by the latter in relation to the development properties to be sold to MTRCL. The payments for the costs of these works not yet received by KCRC are currently valued at \$2.31 billion.

Valuation

24. In agreeing the financial terms with MTRCL, the Government has sought to structure the financial terms in order to capture the likely future performance of the KCR System. Under the proposed revenue-sharing method as set out in paragraph 23(c) above, KCRC would share the upside benefits of the financial performance of the KCR system within MergeCo, and is partially protected from lower performance by the fixed payment components. At the moment, many parts of the KCR system are newly commissioned or under construction, and these parts will see an increase in patronage and revenue some time after they are commissioned and in operation. In that event, KCRC will enjoy the upside under the revenue-sharing mechanism

25. Under the financial terms in paragraphs 23(a) and 23(b) above, KCRC will receive an upfront payment and fixed annual payments with an aggregate value over the initial period of the service concession of \$41.8 billion in money-of-the-day (MOD).

26. The value of the annual variable payments to be received by KCRC will depend on the actual revenues generated by the KCR system within MergeCo. The Government has reviewed the likely outcomes of a range of growth and development projections for the KCR system.

Based on these alternative scenarios, the NPV of the total of annual fixed and variable payments that KCRC could be expected to receive will be in the range of $30 billion to $56.5 billion. While the value of variable payments ultimately could be higher or lower than these figures, it would reflect the actual performance of the KCR System.

27. In considering the deal structure, Government also examined the alternative of adopting an outright sale model. However, in any outright acquisition, it is very likely that the potential buyer would emphasize any under-performance by KCRC while downplaying the long-term potential of the system. This is particularly important as many projects of the KCR railway system are either newly completed or still under construction. It will take quite some time before the full earning potential of the system can be realized. As such, to avoid disposal of KCRC's assets at a severely diminished valuation, Government has therefore sought a structural solution under which KCRC could retain ownership of the assets, capture the upside of KCR railway's performance under a revenue-sharing mechanism and can get back a fully operational railway system at the end or upon early termination of the service concession.

Property package

28. The property package of the rail merger proposal comprises the following:

(a) MTRCL to purchase KCRC's investment properties, property management business and property development rights in respect of six existing KCRC property sites, plus two property sites along KSL currently held by Government (a list of the properties and businesses is at **Annex B**);

Annex B

(b) introduction of a railway property development control mechanism to enable Government to exercise control under exceptional circumstances on the level of flat production arising from the tender programme for railway property developments; and

(c) MergeCo to replace KCRC as the agent of Government for the development of the property sites along West Rail (WR) on the basis of an incentive scheme.

29. Given that the property package is an integral part of the whole deal, after negotiation with MTRCL and taking into account the advice of the independent valuer, we consider that MTRCL's latest offer of $7.79billion to purchase the properties as a package is acceptable. Separately, MTRCL will reimburse KCRC for enabling works costs already paid for by the latter in relation to the development properties to be sold to MTRCL.

30. Under the proposed property development control mechanism, the Government and MTRCL would conduct an annual exercise to discuss and draw up a three-year rolling programme on the level of flat production arising from tenders for railway property development by MergeCo, with provision for subsequent adjustment to the level of flat production upon mutual agreement by the Government and MergeCo.

New Railway Development and Financing

31. The rail merger would reduce duplication of effort in railway development, the time required for protracted negotiations between the two corporations on project interface issues for future railway projects, and the likely project cost. This would be conducive to the timely delivery of railway projects and would improve interchange arrangements.

32. Under the rail merger proposal, Government would have the right in future to determine whether the 'ownership approach' (under which MergeCo would fund, construct and operate the new railway) or the 'concession approach' (under which Government would fund the construction of the new railway and MergeCo would be granted a service concession to operate the new railway based on financial terms to be determined according to a pre-agreed mechanism) should be adopted for individual new railway projects which are not natural MTR-extension projects. For the SCL, we would further discuss with MTRCL on the

funding and implementation details and consider under which approach the project should be taken forward. For future projects which are natural MTR-extension projects, the status quo would apply i.e. Government would discuss the financial arrangement for the new project with MergeCo on the basis of the ownership approach.

33. In considering the financing arrangements for future new railway projects, the Government would continue to examine carefully whether financial support should be provided having regard to the circumstances of individual cases, so as to ensure that maximum benefits for the public would be achieved from railway development. The Government would take a view on the most suitable mode of financing, including the grant of property development rights within the precinct of the railways or other measures, on a case-by-case basis.

Regulatory Regime

34. Under the proposed rail merger, MergeCo would be granted a franchise to operate the MTR and KCR railways. The existing regulatory regime for MTRCL would be adopted with suitable modifications to incorporate the changes required for the inclusion of KCR services. The existing Operating Agreement between MTRCL and the Government would be expanded into an integrated Operating Agreement (IOA) to cover the regulation of the operation of the KCR railways by MergeCo. MergeCo would be subject to the existing requirement to maintain proper and efficient service and to meet the required service and safety standards as prescribed in the IOA. The Hong Kong Railway Inspectorate would retain the statutory powers to inspect the railways and investigate into railway incidents/accidents with a view to ensuring the safety of railways and railway premises.

35. The existing provisions for extension, suspension and revocation of franchise would largely be followed. The franchise of MergeCo would be extendable by application or by reason of the amount of capital expenditure invested by MergeCo on the railway network, subject to approval by the Chief Executive in Council. The franchise could be suspended or revoked by the Chief Executive in Council on

specified grounds as prescribed in the MTR Ordinance. New provisions would be added to provide, upon franchise revocation or expiry, for the access arrangements to enable KCRC to access the assets owned by MTRCL but which are used commonly by the MTR and KCR systems (and vice versa). In view of the service concession arrangement to enable MTRCL to use KCRC assets to operate the KCR system after the rail merger, in future a major default by MergeCo in fulfilling its obligations in the service concession agreement with KCRC could trigger revocation of the franchise as it relates to the KCR railways.

Human Resource integration into "One Company, One Team"

36. In parallel to our negotiations with MTRCL on the terms for the rail merger, there have been on-going discussions between the two corporations and the Government on matters concerning human resource integration. The two corporations have agreed that all serving staff would be employed by MergeCo on their prevailing terms and conditions upon the rail merger. The two corporations would conduct further studies on the setting of one set of terms and conditions for all serving staff after the rail merger and they would consult staff during the process. The transfer of employment to MergeCo would be deemed for all purposes to be a single continuous employment.

37. The two corporations have reaffirmed that they are committed to looking after the interests of all staff. They have agreed that future staff arrangements would be handled fairly and equitably in the rail merger exercise. They would step up discussions to develop the procedures and guidelines for the process of selection of staff into positions in MergeCo in due course after final approval of the rail merger. In future, the staff of MTRCL and KCRC would work as one team in the same company.

38. The two corporations have estimated that there would be net increase in job positions after the rail merger. They estimated that there would be more than 1,300 staff vacancies in the first three years arising from new jobs created due to business growth of MergeCo, in particular the opening of new railways, and from natural wastage and turnover of

existing staff. This number exceeds the corporations' estimate of an overall staff synergy of 650 - 700 full-time equivalents (FTE)[7] expected to be achieved over a number of years as a result of the rail merger. Therefore from the overall perspective, there would be more career development opportunities to staff after the rail merger. To address any potential mismatches in skills, MergeCo would offer re-training and redeployment for affected staff.

39. The two corporations would conduct thorough and comprehensive studies in various human resource areas in preparation for a smooth integration. They have undertaken that they would maintain direct communication with staff and their staff would be consulted on matters affecting them in the rail merger exercise.

Top-level appointments to MergeCo

40. The Chairman (designate) of MergeCo would be selected by the Government, and the Chief Executive Officer (designate) would be selected by the Government in consultation with the Chairman (designate). On the selection of the other members of the Executive Directorate of MergeCo, the arrangements would be as follows:

(a) the Chief Financial Officer (designate) and the Chief Operations Officer (designate) (or their equivalent in MergeCo) would be selected by an appointment panel consisting of the Secretary for the Environment, Transport and Works, the Secretary for Financial Services and the Treasury, the Chairman (designate) and the Chief Executive Officer (designate); and

(b) the other Executive Directors (designate) would be selected by the Chairman (designate) and the Chief Executive officer (designate).

41. The Government would determine the number of additional non-executive directors to be appointed in forming the Board of Directors

[7] "Full-time equivalent" refers to the equivalent number of full-time posts.

of MergeCo. The additional non-executive directors would be selected by the Government in consultation with the Chairman (designate). All these selections would be conducted before the rail merger package is put to the minority shareholders of MTRCL for approval.

Legislative Exercise and Necessary Approval by MTRCL's minority shareholders

42. There would need to be amendments to the MTR Ordinance as well as the Kowloon-Canton Railway Corporation Ordinance to provide for the implementation of the rail merger. For example, legislative amendments would be required to empower MergeCo to operate the KCR services, with the intention that the operation of the MTR and KCR systems after implementation of the rail merger would be regulated in substantially the same way as the MTR before the rail merger. There would also be suitable amendments in relation to the existing provisions on the suspension, expiry and revocation of franchise as a consequence of the expansion of the scope of the franchise to cover both the MTR and KCR railways.

43. The rail merger package also needs approval by the minority shareholders of MTRCL. Government, being the majority shareholder of MTRCL and the sole shareholder of KCRC, would be regarded as a connected party under the Listing Rules and would therefore not be allowed to vote on any resolution put forward in connection with the rail merger package.

Functions of KCRC after the rail merger

44. After the rail merger, KCRC would cease to have any railway operating function. We envisage that it would retain certain administrative, accounting and treasury functions with the Managing Board comprising solely of Government officials and with operations supported mainly by outside service providers.

Considerations for the Way Forward

45. Having regard to the five parameters we set for the merger discussions, we consider that the proposed rail merger would be able to -

(a) address public expectation of fare reduction;

(b) meet public demand for a more objective and transparent FAM that would allow fares to reduce as well as increase;

(c) improve the interchange arrangement for SCL and reduce duplication of network for future railway projects;

(d) provide a barrier-free and seamless interchange environment for rail passengers; and

(e) allow better use of resources under an integrated railway system.

46. MTRCL has indicated that the proposal being offered is a package deal for the rail merger. Based on the proposed terms, we have entered into a non-binding MOU with the MTRCL.

47. In mapping out the way forward, the Government would take into account Members' views and comments from the public and other stakeholders. If there is general support for the rail merger, we would proceed with the necessary legislative exercise and submit a bill to the Legislative Council. There would need to be suitable amendments to the MTR Ordinance and the Kowloon-Canton Railway Corporation Ordinance to provide for implementation of the rail merger.

48. MTRCL's minority shareholders would be invited to approve the merger proposal if and after the necessary legislative amendments have been approved by the Legislative Council.

Environment, Transport and Works Bureau
Financial Services and the Treasury Bureau
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