

For discussion
26 May 2006

Legislative Council Panel on Transport

Rail Merger - Proposed Steps for the Legislative Exercise

Purpose

This paper briefs Members on the broad legislative proposals for implementing the proposed merger of the Mass Transit Railway (MTR) and Kowloon-Canton Railway (KCR) systems and sets out the proposed steps for the legislative exercise.

Background

2. On 12 April 2006, we briefed the Panel on Transport and the Panel on Financial Affairs on the proposed merger package and our plan for the next steps. Details are set out in paper CB(1)1291/05-06(01). We had further discussions with the Panel on Transport on staff-related matters on 28 April 2006, and joint meetings with the two Panels are scheduled for 22 and 23 May 2006 to discuss fare-related matters and the finance/property package respectively.

3. It is necessary to make amendments to the Mass Transit Railway Ordinance, Cap.556 (MTRO) and the Kowloon-Canton Railway Corporation Ordinance, Cap.372 (KCRCO) to implement the proposed rail merger. The relevant Bill is under preparation. Paragraphs 4 to 12 below explain the broad legislative proposals.

Basic approach

4. Under the proposed structure for the rail merger, the Kowloon-Canton Railway Corporation (KCRC) would enter into a

service concession agreement (SCA) with the MTR Corporation Limited (MTRCL) to grant MTRCL the right to use its assets to operate the existing KCR railway lines and (upon their completion) certain new KCR railway lines under construction as well as its other transport-related businesses such as bus operation in the North-west Transit Service Area (TSA bus); MTRCL would purchase a property package and certain short-lived railway assets of KCRC such as stores and spares via sale and purchase agreement(s); MTRCL would maintain its listing status and would be the legal entity of the post-merger corporation (MergeCo); MergeCo would be granted a franchise to operate the MTR and KCR railways for 50 years after the merger; the SCA would be coterminous with the franchise of MergeCo; and 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 both the MTR and the KCR railways by MergeCo.

5. On this basis, we will propose suitable amendments to the MTRO and KCRCO in one Bill to expand the scope of the franchise, transfer the employment contracts of KCRC staff to MergeCo, and introduce appropriate enabling and consequential provisions for the purpose of the rail merger. The amended MTRO would be the governing legislation of MergeCo. The IOA would prescribe the required service and safety standards of MergeCo's railway operation and the fare adjustment mechanism.

Broad proposals to amend the MTRO

Right to operate KCRC's railway and bus services

6. MTRCL was granted a 50-year franchise under the MTRO in 2000 to operate the MTR. In pursuance of the rail merger, the duration of the franchise would be reset to run for 50 years from the date of implementation of the rail merger (Merger Date), and the scope of the franchise would be expanded from the Merger Date to allow MergeCo to:

- (a) operate the existing and new KCR railway lines under construction including the Kowloon Southern Link and Lok Ma

Chau Spur Line upon their completion;

- (b) construct and operate any railways which are not extensions to MTR if Government decides to adopt the ownership approach to implement such projects; and
- (c) operate any railways which are granted to MergeCo by way of a service concession from KCRC,

in addition to MTRCL's existing powers to operate the MTR and any extension thereof and to construct any extension to the MTR during the franchise period.

7. At present, the TSA bus operation is regulated by way of passenger service licences issued by the Transport Department under the Road Traffic Ordinance, Cap. 374 and is subject to certain provisions in the Public Bus Service Ordinance, Cap 230. MergeCo's operation of TSA bus service after the rail merger would be regulated in the same way.

Extension, revocation and suspension of franchise

8. The existing provisions in the MTRO for the extension, revocation and suspension of franchise would continue to apply, subject to the following modifications:

- (a) At present, the franchise can be revoked or suspended by the Chief Executive in Council on specified grounds as prescribed in the MTRO. The Bill will contain provisions to stipulate that the grounds for franchise suspension would in future cover relevant matters concerning the operation of the KCR railways. The grounds for franchise revocation would in future cover relevant matters concerning the operation of the KCR railways as well as substantial failure by MergeCo to comply with an obligation under the SCA which has certain significant consequences such as endangering passenger safety.
- (b) In view of the service concession arrangement to enable MergeCo to use KCRC assets to operate the KCR railways after

the rail merger, the Bill will contain provisions to stipulate that in future a major default by MergeCo in fulfilling its obligations in the SCA with KCRC (e.g. payment default, breach of the restrictions against disposals or the creation of security) would trigger procedures for revocation of the franchise as it relates to the KCR railways. MergeCo would retain the franchise as it relates to the MTR in this situation, provided that there is nothing untoward in the operation of those railways that would trigger the procedures for revocation of the whole franchise as mentioned in sub-paragraph (a) above.

- (c) There are existing provisions to enable Government to take possession of assets for the operation of the MTR upon franchise revocation, suspension or expiry and to provide for the liability of Government to pay compensation to MTRCL under specified circumstances for the assets so possessed. The Bill will contain corresponding provisions in respect of assets covered in the SCA for the operation of the KCR system.
- (d) Upon progressive integration of the MTR and KCR systems in future, there would be assets used for the operation of both the MTR system and the KCR system (Common Assets). The Bill will contain provisions stipulating that there shall be arrangements to enable Government to use the Common Assets of MergeCo upon franchise revocation, suspension or expiry. There will be provisions for MergeCo, upon revocation or suspension of the franchise as it relates to the KCR railways, to use those Common Assets of KCRC which had been taken possession of by Government for the operation of the MTR.
- (e) The existing MTRO requires MTRCL to maintain a proper and efficient service and stipulates that in approving an extension of MTRCL's franchise, the Chief Executive in Council needs to be satisfied that the Corporation is capable of maintaining a proper and efficient service. The Bill will contain provisions to make it clear that during the concession period, the "service" referred to in the relevant provisions covers the KCR railway and TSA bus services as well.

Employment-related matters

9. The Bill will contain specific provisions for transferring the employment contracts of all serving KCRC staff at the time of the rail merger to MergeCo with continuity of their existing retirement benefits and for dealing with other employee-related issues. The purpose is that upon the Merger Date:

- (a) all serving staff of KCRC immediately before the Merger Date would be deemed to be employed by MergeCo from the Merger Date; and
- (b) the employment contracts of all serving KCRC staff at the time of the rail merger and the prevailing retirement schemes relating to KCRC staff would be vested in MergeCo so that, among other things:
 - (i) the vested employment contracts would be construed from the Merger Date as if MergeCo had been a party thereto instead of KCRC, as the case may be; and
 - (ii) each vested employment contract would be deemed for all purposes to be a single continuing employment.

Treatment of other KCRC's contracts, licences, permits, etc.

10. MTRCL is conducting a due diligence exercise in relation to KCRC business. After the due diligence exercise is completed in the next few months, we would be able to take a view on how to deal with the transfer of the relevant contracts etc. for the purpose of the rail merger, on the basis of the understanding we have reached with MTRCL on the terms for the merger transaction.

Other miscellaneous and consequential amendments

11. The Chinese name of MTRCL and of the MTRO will be amended. The Bill will also contain provisions to make consequential amendments to other relevant Ordinances such as amendments required

due to the change to the Chinese names of MTRCL and the MTRO.

Broad proposals to amend the KCRCO

12. After the rail merger, KCRC would cease to operate railway and bus services while it would retain certain administrative, accounting and treasury functions. The following changes to the KCRCO would be required:

- (a) To empower KCRC to grant the right to MTRCL to use its assets for operation of its railway and bus services by way of a service concession and, in connection with the service concession, to dispose of its assets.
- (b) To make it clear that KCRC shall not exercise its power under the KCRCO to operate railway and bus services nor to construct new railways during the concession period.
- (c) To make it clear that KCRC is not required to appoint a Chief Executive Officer during the concession period.
- (d) To make consequential change to the composition of the Managing Board to take into account the proposal in sub-paragraph (c) above.
- (e) To change the quorum of the Managing Board from five to a simple majority of the members of the Managing Board during the concession period, as we envisage that the size of the Managing Board of KCRC would be around five during the concession period when the corporation would have no transport operation function.

Proposed steps for the legislative exercise

13. The Regulations and bylaws made under the MTRO would need to be modified or expanded to cover relevant matters concerning the KCR

railway and bus services. Amendments to the relevant subsidiary legislations will be introduced into this Council should the Bill to implement the rail merger be approved by this Council. We will brief any Bills Committee to be set up by this Council to scrutinize the Bill on the proposed changes to the relevant subsidiary legislations in due course.

14. Drafting of the Bill is in progress. We aim to introduce the Bill into this Council as soon as possible, hopefully before the summer recess. Should the Bill be approved by this Council, MTRCL would then proceed to hold an Extraordinary General Meeting for its minority shareholders to approve the merger package.

Environment, Transport and Works Bureau
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