

File Ref.: FIN CR 1/4651/01

LEGISLATIVE COUNCIL BRIEF

Loans Ordinance
(Chapter 61)

Resolution to Authorise the Securitisation of Future Revenue from Government Toll Roads

INTRODUCTION

At the meeting of the Executive Council on 16 December 2003, the Council ADVISED and the Chief Executive ORDERED that the Resolution under section 3(1) of the Loans Ordinance, at Annex A, should be introduced into the Legislative Council to enable Government to securitise its revenue from toll roads by offering notes backed by such revenue to investors.

JUSTIFICATIONS

2. We plan to raise proceeds through securitising future revenue from Government toll roads over a defined period of time (the “proposed securitisation”) because of the considerations set out in paragraphs 3 to 6 below.

(A) Improving Our Fiscal Position

3. Improving our economy is a key step towards addressing our fiscal situation. However, we cannot rely on economic growth alone to resolve the problems. To this end, Government will enforce strict financial discipline in controlling its operating expenditure. At the same time, however, we recognise that Government must maintain its investment in infrastructure so as to reinforce Hong Kong’s attraction as an international

trade, transport and communications hub. To avoid the situation in which Government needs to reduce overall spending through cutting capital spending, we must identify alternative sources of funds for our investment. One way is to dispose of or securitise our assets selectively as announced in the 2003-04 Budget.

4. Proceeds to be raised from the proposed securitisation together with the sale of loans to Hong Kong Mortgage Corporation completed earlier will bring in about \$21 billion of capital revenue, in line with our estimate in the 2003-04 Budget. Not only will this help partially off-set our expected \$31 billion expenditure in capital works projects in 2003-04, but achieving our target set in the Budget will also signify Government's continual effort to look for alternative sources of revenue. Most importantly, it demonstrates that we will continue to invest for Hong Kong's future.

(B) Preparing for the Future

5. The securitisation will be implemented by the issue of notes or other financial instruments ("notes") backed exclusively by revenue from Government toll roads. Such notes are often regarded by investors as investment similar to bonds. Whilst the notes issued would have a different profile to government bonds, should Government decide to borrow through the issue of its own bonds in future to fund its capital spending, notes issued under this securitisation proposal, subject to prevailing market conditions, would be a useful precursor to the development of the investor base for future bond issues by Government.

(C) Developing Our Financial Markets

6. Market development is not the main objective of the securitisation. That said, Government would lead in product development and promotion of public awareness through offering of revenue backed notes to the market, thus deepening, stabilising and broadening Hong Kong's capital markets. This will benefit all market participants including retail investors by providing an investment alternative. Ultimately, this will help maintain Hong Kong's position as an international financial centre.

THE PROPOSAL

7. The proposed securitisation structure and indicative terms are illustrated at Annex B. This is subject to refinement after we engage our arrangers for the execution of the transaction and after discussion with regulatory authorities and credit rating agencies during the next few months. In brief, Government will issue notes to investors through a wholly-owned special purpose issuer (“issuer”). Such notes will entitle the investors to be paid annual or other periodic sums serviced from net revenue derived from the operation of the toll roads. Government will not guarantee either the return to investors or the traffic volume of each toll road, but there will be certain recourse obligations of Government (mentioned in (c) below). **Ownership of the toll roads, including control over the arrangements with operators, will be retained by Government.** All of Government’s right to the revenue from the toll roads will fully revert to Government at the end of the securitisation period. Arrangers, and ultimately investors, may require Government to disclose relevant information and provide certain undertakings and/or statements in areas such as operations and transport policy. We will have to finalise such requirements after the details of the offer structure are confirmed and discussion with regulatory authorities and credit rating agencies has been completed. Key areas identified so far in respect of which we may need to consider giving commitments to investors are set out in Annex C and major issues are explained below -

(a) **Transport Policy**

Arrangers and credit rating agencies may require Government to set out its transport policy clearly, and to provide some form of undertakings in that respect insofar as it may affect the traffic flow of the toll roads. We will carefully consider such requests for disclosure and undertakings having regard to their financial implications. We will also work with the financial adviser, and later the arrangers, to produce a mechanism that will give investors adequate comfort while providing sufficient flexibility to Government in implementation of its future transport policy, in particular on cross-harbour traffic.

(b) **Toll Adjustment Risk**

While Government will not guarantee a return to investors or a minimum level of traffic volume, we will discuss with the arrangers and credit rating agencies the extent of risk they would accept in relation to future toll adjustment. If an adjustment in toll levels by Government results in a reduction in toll revenues it may be necessary for Government to make some compensating payment to investors.

(c) **Possible Payment Items**

As investors will have an interest only in the revenue stream but not in the full economic interests in the toll roads and will not have a guaranteed return, it is not unreasonable to expect them to demand payments from the owner of the underlying assets in the event that the toll roads are unable to operate normally and generate the expected revenue over a sustained period, of say several months, due to events which are directly or indirectly under Government's control ("business interruption risk"). Such events may include failure of the operators to perform, failure by Government to renew or appoint a replacement operator, toll adjustments and changes to transport policy.

(d) **Insurance Arrangements**

Government is currently self-insuring the toll roads except items covered under the present agreements for the management, operation and maintenance of the toll roads, which require the operators to take out certain types of insurance. Upon securitisation, the current arrangement may need to be formalised and further insurance in respect of business interruption risk may need to be taken subject to further study of its cost and benefit.

(e) **Other Obligations**

Government will continue to operate the toll roads through operators from the private sector and pay for their management fees from revenue derived from the toll roads as provided for in the Road Tunnels (Government) Ordinance and Tsing Ma

Control Area Ordinance. We will also continue to bear relevant capital expenditures.

(f) **Payment to Investors**

Certain mechanisms will need to be in place to ensure timely transfer of relevant revenues from the toll roads to service the notes. We envisage that the notes will be serviced by an external administrator and a security trustee (if necessary).

8. We aim to resolve all issues, finalise the structure, and execute the necessary legal documents by mid-March 2004 to facilitate the offering of notes to investors, subject to prevailing market conditions. Financial arrangements, including appropriate risk mitigation measures, will also be implemented to enable the offering to proceed.

OTHER OPTIONS

9. Government can only borrow with authorisation from Legislative Council. A resolution under the Loans Ordinance has been identified as the most suitable means to implement the proposed securitisation.

THE RESOLUTION

10. The purpose of the Resolution is to give Government, and so far as necessary a special purpose issuer wholly-owned by Government to be established, the authority to raise up to \$6 billion (net of ancillary expenses) from a securitisation executed by way of issuance of notes and to enter into transactions incidental to carrying this proposal into effect.

LEGISLATIVE TIMETABLE

11. The legislative timetable is as follows –

Moving a motion in the Legislative Council	14 January 2004
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Publication in the Gazette and Commencement	16 January 2004
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IMPLICATIONS OF THE PROPOSAL

12. Subject to market conditions and the finalised structure of the transaction and tenor of the notes, the proposed securitisation is expected to bring in one-off capital revenue of up to \$6 billion in 2003-04. Costs incidental to the execution and the servicing of the notes (e.g. trustee fees), apart from the annual or other periodic sum payable and repayment on maturity, will be met from the proceeds raised. Annual payment and repayment upon maturity of the notes will be met from future revenue from the toll roads.

13. The proposal is in conformity with the Basic Law, including the provisions concerning human rights. The proposal does not have any significant economic and sustainability implications. It has no impact on the civil service system.

PUBLIC CONSULTATION

14. The 2003-04 Budget was debated among the public after its announcement. Briefing by the Financial Secretary to the Legislative Council in October 2003 re-confirmed Government's commitment to dispose of its assets selectively. During the past few months, we have also indicated to the public our intention to securitise revenue from toll roads.

PUBLICITY

15. We will issue a press release. A spokesman will also be available to answer any enquiries.

BACKGROUND

16. Government announced in the 2003-04 Budget its intention to dispose of or securitise \$112 billion of assets in the next five financial years and set a target to raise an estimate of \$21 billion in 2003-04.

17. Subject to market conditions and the final structure and tenor to be agreed with the arrangers, it is estimated that up to \$6 billion can be raised through securitising future revenue⁽¹⁾, over a limited period, from the following toll roads –

- (a) Aberdeen Tunnel
- (b) Cross-Harbour Tunnel⁽²⁾
- (c) Lantau Link (comprising Tsing Ma Bridge, Ma Wan Viaduct and Kap Shui Mun Bridge)⁽³⁾
- (d) Lion Rock Tunnel
- (e) Shing Mun Tunnels
- (f) Tseung Kwan O Tunnel

After completion of this transaction, capital revenue raised from disposing of or securitising Government assets is estimated to reach \$21 billion in 2003-04.

18. In 2002-03, the toll roads mentioned in paragraph 17 above

Notes (1) Future revenue includes toll revenue and other revenue such as advertising.
Notes (2) Please refer to item 3(iii) of Annex C for possible future exclusion.
Notes (3) Subject to confirmation of the economics of its inclusion.

generated gross revenue of about \$1.5 billion to Government. The last time we adjusted the toll level for certain tunnels was in 1999.

OTHERS

19. In case of enquiries about this Brief, please contact Mr Tommy Yuen, Principal Assistant Secretary for Financial Services and the Treasury (Treasury) at 2810 3743.

**The Treasury Branch
Financial Services and the Treasury Bureau
December 2003**

LOANS ORDINANCE

RESOLUTION OF THE LEGISLATIVE COUNCIL

Resolution made and passed by the Legislative Council under section 3(1) of the Loans Ordinance (Cap. 61) on 14 January 2004.

RESOLVED, in exercise of the powers conferred by section 3(1) of the Loans Ordinance, that the Government be authorized to borrow, for the purposes of the Capital Works Reserve Fund established by resolutions passed under section 29 of the Public Finance Ordinance (Cap. 2), a sum or sums not exceeding in total \$6,000,000,000 or equivalent by way of securitizing Government revenue receivable from tolls on bridges and tunnels and such other Government revenue receivable from bridges and tunnels as specified by the Financial Secretary.

Clerk to the Legislative Council

January 2004

Explanatory Note

This Resolution authorizes the Government to borrow a sum or sums not exceeding in total \$6,000,000,000 or equivalent for the purposes of the Capital Works Reserve Fund by way of securitizing Government revenue receivable from tolls on bridges and tunnels (any or all of the Aberdeen Tunnel, Cross-Harbour Tunnel, Lion Rock Tunnel, Shing Mun Tunnels, Tseung Kwan O Tunnel, Tsing Ma Bridge, Ma Wan Viaduct and Kap Shui Mun Bridge) and such other Government revenue receivable from those bridges and tunnels as specified by the Financial Secretary.

LOANS ORDINANCE

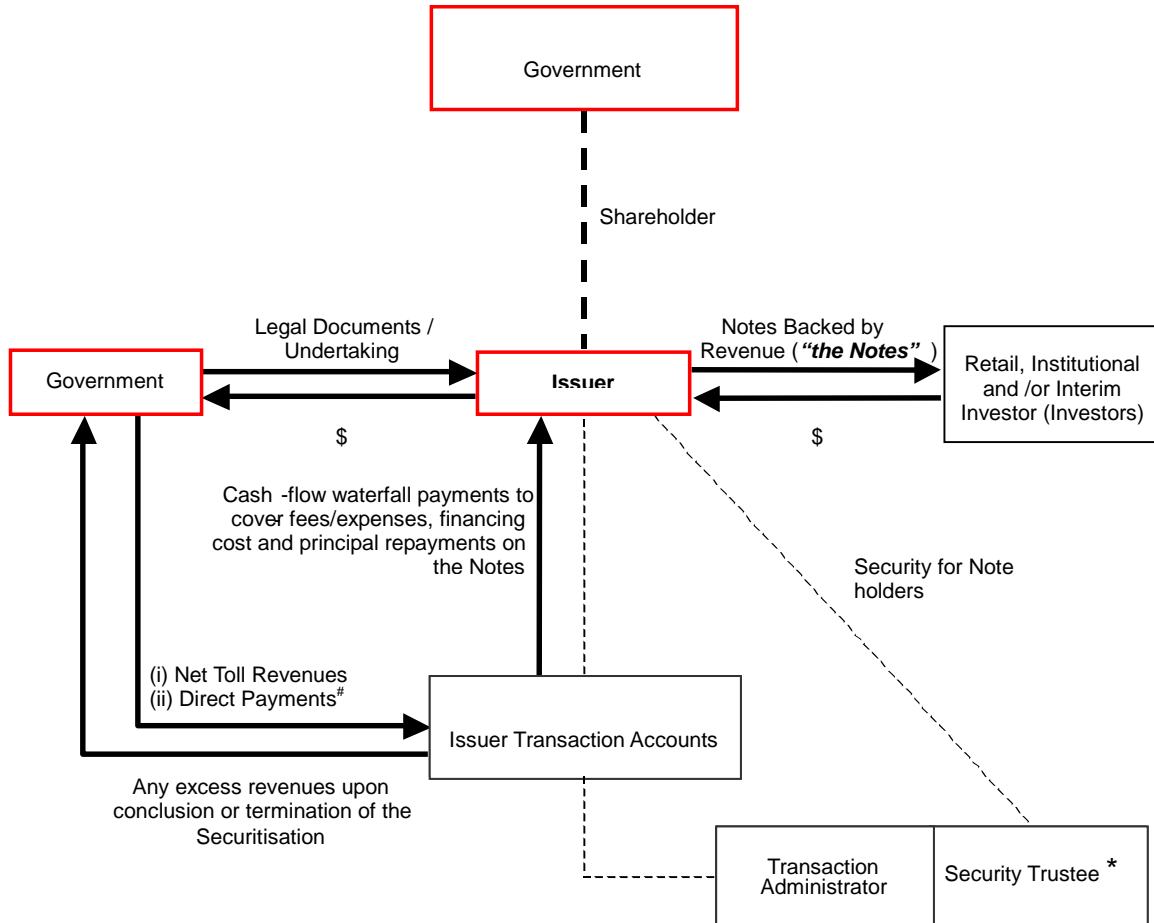
RESOLUTION

(Under section 3(1) of the Loans Ordinance (Cap. 61))

RESOLVED, in exercise of the powers conferred by section 3(1) of the Loans Ordinance, that the Government be authorized to borrow, for the purposes of the Capital Works Reserve Fund established by resolutions passed under section 29 of the Public Finance Ordinance (Cap. 2), a sum or sums not exceeding in total \$6,000,000,000 or equivalent by way of securitizing Government revenue receivable from tolls on bridges and tunnels and such other Government revenue receivable from bridges and tunnels as specified by the Financial Secretary.

**PROPOSED SECURITISATION STRUCTURE
and Indicative Terms and Tenor**

(Subject to refinement and further study)



* If necessary

Please refer to paragraph 7(c) of the main text

Brief Description:

Government will set up a special purpose issuer (*Issuer*) for the purpose of the proposed securitisation. The Issuer's share capital will be wholly-owned by Government. The Issuer will issue revenue-backed securities (*the Notes*) to investors in the capital markets, including possibly interim investors. Net proceeds raised by the Issuer will be channelled to Government possibly through the Issuer

subscribing to a back-to-back note from Government. During the life of the Notes, net revenue from toll roads will be earmarked for the purpose of servicing the Notes. A transaction administrator will administer the payments in accordance with an agreed order of payments (the cash-flow waterfall) and also administer regular transaction reports to investors and/or credit rating agencies. If necessary, a security trustee can be appointed to hold the security package in favour of the investors and provide ancillary services (such as receiving and paying agent).

Expected Net Proceeds:

Around \$5-\$6 billion (net of incidental expenses and reserves)

Currency Denomination:

Primarily Hong Kong Dollars. Foreign currencies, most likely United States Dollars, will be considered.

Investors:

Retail and institutional

Maturity:

Tranches with different maturities with an average maturity of around 8-9 years, assuming Government does not take out any toll roads before the Notes mature.

**Indicative Commitment to the Issuer and Investors
to be Considered by Government**

Subject to the finalisation of the securitisation structure, Government is prepared to consider giving the following commitments to the Issuer (Annex B refers) and therefore the investors –

1. *Toll Revenue*

The Notes issued will be serviced by all toll revenues and other sums received by Government from operators or sureties provided by operators pursuant to their agreements with Government (i.e. liquidated damages).

2. *Capital Expenditure on Tsing Ma Control Area (TMCA)*

The Issuer will not be required to bear the costs of any capital expenditure for TMCA in excess of the revenue received in a particular year (if Lantau Link is included in the transaction).

3. *Possible Payment Items*

The Issuer may receive direct payments from Government in respect of –

- (i) Business Interruption Events (e.g. non-operation of toll roads) due to –
 - (a) force majeure;
 - (b) operator failing to perform or lack of operator; and
 - (c) lack of maintenance of the toll roads.
- (ii) Toll adjustments or revision of agreements with operators resulting in reduction in toll revenue; and

- (iii) Government exercising an option to exclude Cross Harbour Tunnel altogether from the structure after say the first five years of issuance of the concerned notes through early redemption. In addition, instead of early redemption of the concerned notes, Government may elect to make relevant direct payments to the Issuer calculated according to an agreed formula based on traffic volume, in exchange for a release of its obligation to pay to the investors actual revenues derived from the Cross Harbour Tunnel.

4. *Insurance Obligations*

The following insurance arrangements will be in place –

- (i) property damage – other than existing insurance cover taken out by the operators under their respective operating agreement, Government will continue to self-insure this risk; and
- (ii) machinery breakdown and public liability (third party risks)– Government will continue the present arrangement of requiring its appointed operators to take out insurance to the extent necessary.

5. *Undertakings to Issuer*

Government will undertake that –

- (i) the agreement entered into by Government and the rights of the security trustee (if necessary) are legal, valid, binding and enforceable;
- (ii) it will not grant any other right or interest in the toll roads or assign or part with the interest in the agreements with operators;
- (iii) it will be responsible for collecting and making payment to the Issuer of all net toll revenue; and

(iv) it will make certain direct payments, subject to obtaining necessary approval from the relevant authority.

6. *Swap and Hedging*

To the extent necessary, to enter into swap arrangement to hedge against currency and/or interest rate risks.