Information Paper to Legislative Council Transport Panel

Supplementary Information on the Review of the Basis for Considering Bus Fare Adjustments

I. Purpose

At the meeting on 27 October 2000, the Administration briefed the Panel on the results of the review on the basis for considering bus fare adjustments and sought members' views on our proposals to improve the existing arrangement. At members' request, we agreed to provide supplementary information on –

(a) the reasons for not using shareholders' investment as the basis for measuring a franchised bus operator's rate of return; and

(b) the calculation of the 13% historical average rate of return of the local bus industry in the past 10 years.

The relevant information is given below.

II. Reasons for not using shareholders' investment as a basis for measuring an operator's rate of return

2. A bus operator can finance its operation by shareholders' investment and/or by borrowing. The capital structure of a company is a business decision and if a bus company wants to finance its operation through borrowing, the Administration considers that the shareholders should bear the borrowing costs. Therefore, under the proposed Modified Basket of Factors *(MBOF)* approach, an operator's return includes both the net profits to shareholders and the borrowing costs incurred, rather than including only the net profits to shareholders in calculating return. As return is defined to include borrowing costs in addition to shareholders' profits, it is not appropriate to measure a bus operator's rate of return on the basis of shareholders' investment.

3. On the other hand, if we were to exclude borrowing costs in calculating return and to measure a bus operator's rate of return by benchmarking only the shareholders' profits against their investment, it would not serve the purpose of requiring the shareholders to bear the borrowing costs, which would act as an incentive against over-reliance by bus operators on borrowing as a means to finance their operation.

III. **Calculation of the 13% historical average rate of return**

4. Under the proposed MBOF approach, if in any year a bus operator achieves a rate of return above the average rate of return in the local bus industry in the past 10 years (1990-1999), any above-average return achieved by the operator would be shared equally on a 50/50 basis between the operator and passengers. The historical average rate of return of the bus industry in the past 10 years will be used as the trigger point for the sharing of above-average return. This rate is 13%, worked out by averaging the actual rates of return on average net fixed assets achieved in respect of all bus franchises which existed during 1990-1999:

- Kowloon Motor Bus Company (1933) Limited *(KMB)*'s franchise;
- China Motor Bus Company Limited *(CMB)*'s franchise (which ended in 1998);
- Citybus Limited *(Citybus)*'s franchise on urban routes (which commenced in 1993);
- Citybus' airport bus franchise (which commenced in 1997);
- Long Win Bus Company Limited *(Long Win)*'s airport bus franchise (which commenced in 1997);
- New Lantao Bus Company (1973) Limited *(NLB)*'s franchise; and
- New World First Bus Services Limited *(NWFB)*'s franchise (which commenced in 1998 following the expiry of CMB's franchise).

5. The above calculation method has taken into account the different operating circumstances of different bus operators and the changing business environment in the past 10 years. For example, both the low returns achieved by some new operators in their early years of operation and the stable returns achieved by the more mature operators have been taken into account. Alternatively, if we were to exclude the past financial results of those bus franchises which were subject to the Profit Control Scheme *(PCS)* (i.e. exclude the financial results of KMB in 1990-1997 and of CMB in 1990-1993), the resulting average rate of return would be 12.2%.

6. In our view, the historical average rate of return calculated by using the method explained in paragraph 4 above is representative of the past financial performance of the bus industry as a whole because the financial results of <u>all</u> the then existing bus franchises have been taken into account, irrespective of whether the operator was a new entrant or a mature company in the industry, or whether the operator was subject to the PCS or not. In this connection, it should be noted that among the seven franchises then existing in 1990-1999, five were never subject to the PCS; as regards the remaining two franchises, the PCS had ceased to apply to CMB in 1993 and to KMB in 1997. The "PCS-driven" financial results account for only a small proportion of the past results which were taken into account in calculating the 13% historical average rate of return. If we include the past financial results of certain bus franchises only on a selective basis in calculating the historical average rate of return of the bus industry, the resulting figure would be different and biased one way or the other.

7. As explained above, we consider that the past financial results of <u>all</u> the then existing bus franchises should be taken into account in calculating the historical average rate of return of the local bus industry. Under this calculation method, the average rate of return of the bus industry in the past 10 years is 13%. This rate will be used as the trigger point for the sharing of above-average return of the bus operators under the MBOF approach.

Transport Bureau
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