LegCo Transport Panel Paper

Review of the Basis for Considering Bus Fare Adjustments

I. Purpose

1. The Administration has completed a review of the basis for considering bus fare adjustments. This paper informs Members of the results of the review and seeks Members' views on our proposals to improve the existing arrangement.

II. Background

2. Under section 13(1) of the Public Bus Services Ordinance, the scales of bus fares are determined by the Chief Executive in Council. In assessing bus fare adjustment applications for the purpose of making recommendations to the Chief Executive in Council, the Administration takes into account a number of factors which include -

(a) changes in operating costs and revenue since the last fare adjustment;
(b) forecasts of future costs, revenue and return;
(c) the need to provide the operator with a reasonable rate of return;
(d) public acceptability and affordability; and
(e) the quality and quantity of service provided.

These general criteria are known as the Basket of Factors (BOF).

3. The advantages of the BOF approach are that :

- it is comprehensive and can take account of all relevant factors; and

- it is flexible and can take account of the different circumstances of different bus operators as well as changes in the business environment.

There have been suggestions that the transparency and objectivity of the current arrangement can be improved. Against this background, we have conducted a review of the basis of considering bus fare adjustments.

III. **The review**

4. The review seeks to develop a more objective basis for considering bus fare adjustments. A spectrum of schemes has been examined, ranging from the Rate of Return regime (focusing on return on investment) to the Price-cap model (focusing on fares to consumers). The main features of the two schemes are set out at the Annex.

Annex

5. Whilst each of these schemes has its own merits and demerits, both of them involve a mechanical and automatic formula for fare adjustments. Inherent in any fare determination formula is that fares would be automatically increased or otherwise based on a number of pre-established criteria. Such an approach would allow little flexibility to take into account the different degree of maturity and operating environment of different bus operators in Hong Kong as well as changes in the business environment.

6. As part of our review, we have also examined how bus fare adjustments are determined in other cities. However, because public transport services in most other cities are provided by the public sector and subsidised by taxpayers, there are no useful parallels which could be drawn.

IV. **Proposals**

7. We propose to build on the BOF approach and introduce suitable modifications to improve its objectivity and transparency. Our proposals are :

(a) To continue to take into account all relevant factors including those factors under the BOF approach outlined in paragraph 2 above in considering future bus fare revision applications.

(b) To set out in a more objective basis how we would consider public acceptability of the rate of fare adjustment. In future, reference would be made to changes in the Composite Consumer Price Index (CCPI) when we consider the acceptability of the rate of fare adjustment to the public.

(c) To introduce a new arrangement in order to stabilize future fares. In future, any return achieved by a bus operator on top of the historical average rate of the local bus industry would be shared equally on a 50/50 basis between the operator and passengers, i.e. 50% of the relevant portion of the return would be treated as revenue in future fare increase exercises. This arrangement would help relieve the pressure for future fare increases. On the other hand, by allowing the operators to take 50% of such returns, it would provide an incentive to the operators to continue to improve their efficiency. The average rate of return in the local bus industry in the past 10 years (1990-1999) is 13.0%. This rate will be used as the trigger point for this profit-sharing arrangement.

8. As in the case of the BOF approach, under this proposed arrangement, the operators will not be guaranteed of any specific rate of return. In considering reasonable rate of return to operators, reference would be made to the historical rates of return on average net fixed assets (ANFA)[1] of the franchised bus operators.

9. As explained above, we would maintain suitable flexibility in considering bus fare adjustment applications. The proposed arrangement will not operate as an automatic formula. Take the factor of making reference to changes in the CCPI as an example, the operators will not be guaranteed a fare increase at a rate equal to the change in CCPI, nor will the reference to the change in CCPI be an

[1] ANFA is the average value of assets at historical cost net of depreciation, except for land where no depreciation is charged. Return is the sum of the net profit to shareholders (i.e. profit after taxation) and the borrowing costs incurred by the operator. Return on ANFA is to measure an operator's return on its investment in the fixed assets.

absolute cap on fare adjustment. Each case would be considered on its own merits taking into account all the relevant factors.

10. The proposed arrangement, which may be referred to as the Modified Basket of Factors (MBOF) approach, will be subject to review every five years to take into account changes in the operating and economic environment. This would provide certainty to bus operators to plan and conduct their business during the 5-year period, and reasonable time to see the results of their efficiency measures. It is noted that the fare setting process of major industries in many overseas countries are also reviewed every five years.

V. **Advice sought**

11. Members are requested to give their views on the proposed MBOF approach outlined in paragraphs 7-10 above.

October 2000
Transport Bureau

Annex

Rate of Return Regime	**Price-Cap Model**
• Based on forecast cost and revenue and a specified rate of return	• Capped by a CPI±X% formula
• Regulator specifies a reasonable rate of return • Specified rate may be reviewed every 5 years or so	• "X" is established taking into account - forecast operating costs - forecast cost of capital - expected cost savings - forecast patronage • value of X may be reviewed every 5 years or so
• Fares are reviewed on an annual basis and revised to allow the operators to earn the specified rate of return	• Fares are adjusted automatically on an annual basis according to a specified formula, which is based on the rate of inflation plus or minus a pre-determined percentage
• Little incentive for operators to improve cost efficiency	• Strong incentives for operators to cut costs and improve efficiency
• Strong incentive for investment	• Little incentive for operators to invest in non-revenue generating assets, such as depot facilities, or to operate loss-making routes
• Operators tend to under-forecast their patronage and over-forecast their cost	• Same as left
• Correction features may be introduced to capture profit above the specified rate of return, e.g. establishment of a fare stabilization fund	• Correction mechanisms may be introduced to adjust the pre-determined "X"% for any unforeseeable change in uncontrollable costs (such as fuel price) and patronage

Rate of Return Regime	**Price-Cap Model**
• Could be seen as a guarantee of a specified rate of return to bus operators	• More rigid. Cannot take into account the changing operating and business environment of the local bus industry. Requires very accurate forecasts over a period of time which is not available given the uncertainties in the operating and business environment faced by the bus companies. Wrong forecasts may result in excessive returns or lower returns for bus operators.
	• Never tested in the bus industry anywhere.