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2 February 2005

Hon Lau Kong-wah, JP
Chairman
Legislative Council Panel on Transport
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Mr Lau

Fare Adjustment Mechanism

We note your interest in the fare adjustment mechanism for franchised bus operators and would like to take this opportunity to thank you for your concern and to provide you with some background information that we hope will serve to better inform you of our own perspective on this topical matter.

First of all, we fully support the objective of having a formula-based approach to fare reviews which allows fare adjustments to be made automatically and objectively. The main issue however is how to identify and to measure the relative cost factors so that bus operators can provide services meeting these costs.

According to many commentators, it has been suggested that the consumer price index (CPI) should be used as a major basis for measuring general cost fluctuations within the bus industry but if one looks closely at bus operating costs, it can be seen that over 45% of these are expended on salaries whilst another 13% are expended on fuel, both of these being items that do not change in accordance with any direct relationship with CPI. Less than 10% of our total costs can benefit from domestic deflation whilst the other 90% are non CPI related.

For example, despite the recession of recent years, we have not just *maintained* the salaries of our staff but we have also paid them special allowances in spite of their cost of living decreases as reflected by the drop in CPI. Certainly, the wages and salaries of bus company staff have not been adjusted *downwards* in line with deflation. Moreover, as far as fuel and spare parts are concerned, during those years when deflation persisted, not only has the cost of fuel increased substantially but the cost of purchasing consumable spare parts has also increased (as a result of the currency appreciation of European countries coupled with imported inflation from those countries). And as if this is not enough, the costs of third party insurance premiums and tunnel tolls have also increased, once again, these costs having been influenced by factors that are completely outside the control of the bus operator and are clearly not, in any way, linked to the local CPI index.

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Over the past year, we have been engaged in discussions with Government, exploring various ways to develop an objective mechanism which would relate to the conditions expected of our operations in the coming year. Before any new mechanism is applied however, it should be noted that fares are already regulated by Government under the 'modified basket of factors' (MBOF) approach which takes into consideration a host of factors in determining bus fares. In fact, you may remember that it was intended that this approach would be reviewed after a period of 5 years starting from December 2000. Accordingly, whatever events that have occurred in the interim period in terms of wage agreements, distribution of dividends, operating changes etc are events that have been governed under the MBOF 'mechanism' for fare adjustments. This is an important point, when once considers the need for a new mechanism to be 'forward looking.'

Apart from cost considerations, a fundamental objective of the fare determination process is that it should be incentive-based. That is, it should encourage the bus companies to stimulate efficiency improvements whilst also affording due recognition to the fact that negative productivity gains may well result from factors outside an operator's control (in the event, for example, that traffic flows are materially impaired by rising congestion or in the event that 'revenue per km' is diluted on account of the building of more and more railways and, in particular, the very serious threats we are potentially facing from the Shatin/Central link and South Island Line proposals). We hope therefore that in any discussions on the fare adjustment mechanism, you would take into consideration our operating environment, the adverse market conditions that are confronting us and the dedication and commitment of our operations staff in serving Hong Kong.

At this time of impending change, we would also wish to respectfully point out that Franchised bus operators in Hong Kong are world renowned for providing an efficient, high quality public transport service at socially acceptable fares and without any direct subsidy. In fact, the present Hong Kong situation represents an enviable state of affairs that should not be jeopardised unduly. One of the reasons for this success is that the bus operators have adopted prudent commercial principles which are rewarded with a reasonable return to encourage continuous investment. This virtuous cycle has provided, in its turn, a certain stability for our staff during difficult times and even, of late, the prospect of concession fares for our customers that have also been offered during those same difficult times of rising costs and falling revenues.

Undoubtedly, any new mechanism could only be a success if it is fair and able to achieve a satisfactory arrangement for all stakeholders - being the public at large, the employees as well as the investors. In this connection, please rest assured that we will co-operate with Government in all aspects with a view to working out a practicable mechanism for the future application and in this regard, we hope that we can count on your own understanding and, as far as possible, support during any period of wider-consultation on this issue that may transpire.

In the meantime, we remain.

Yours sincerely

Lyndon Rees
Managing Director