LEGISLATIVE COUNCIL BRIEF

REVIEW OF THE BASIS FOR CONSIDERING BUS FARE ADJUSTMENTS

INTRODUCTION

At the meeting of the Executive Council on 10 January 2006, the Council ADVISED and the Chief Executive ORDERED that-

(a) in assessing franchised bus fare adjustment applications for the purpose of making recommendations to the Chief Executive in Council ("CE-in-Council"), the Administration should continue to take into account a basket of factors in the Modified Basket of Factors ("MBOF") approach as endorsed in December 2000, which include -

(i) changes in operating costs and revenue since the last fare adjustment;

(ii) forecasts of future costs, revenue and return;

(iii) the need to provide the operator with a reasonable rate of return;

(iv) public acceptability and affordability; and

(v) quality and quantity of service provided;

(b) the MBOF approach should be modified as follows -

(i) a formula (supportable fare adjustment rate = 0.5 x Change in Wage Index + 0.5 x Change in Composite Consumer Price Index ("CCPI") – 0.5 x Productivity Gain) should be included as an additional factor in the MBOF approach to enable upward and downward fare adjustments. The formula should not operate as an automatic determinant of fare adjustment outcome; there should be flexibility in applying the MBOF approach in considering bus fare adjustment;

(ii) in considering the reasonable rate of return to franchised bus operator, reference should be made to the Weighted Average Cost of Capital ("WACC") of the bus industry;

(iii) the triggering point for 50/50 sharing of return between bus operators and passengers should be revised from the rate of return on average net fixed asset ("ANFA") of 13% to 9.7%;

(iv) an arrangement on the use of return shared with passengers ("passenger reward balance") should be set up so that a bus operator will be given the flexibility to decide, in consultation with the Administration, when to use the passenger reward balance if the amount is less than 1% of its annual revenue for reducing the magnitude of fare increase required in future, or for providing fare concessions. Bus operators are required to use any amount in the passenger reward balance exceeding the equivalent of 1% of the annual revenue for provision of fare concessions within 12 months since the annual disclosure of the passenger reward balance accumulated;

(v) in considering public acceptability and affordability of bus fare adjustment, reference should be made to the magnitude of change in median household income, in addition to existing reference to changes in CCPI;

(c) the introduction of the fare adjustment formula as an additional factor of MBOF approach, the reference to median household income and WACC, the lowering of the triggering point for sharing of return from 13% return on ANFA to 9.7%, and the passenger reward arrangement as set out in paragraph (b) above will take effect on 10 January 2006, and thereafter from the date of the last fare adjustment. All factors under the existing MBOF approach will be applied on a continual basis with reference to the date of last fare adjustment, or, for franchised bus operators who have not adjusted fares before, the date of commencement of its operation; and

(d) the new fare adjustment arrangement comprising the above improvement measures should be reviewed in three years' time.

BACKGROUND

2. Under Section 13(1) of the Public Bus Services Ordinance ("PBSO"), the scale of bus fares is determined by the CE-in-Council. In assessing bus fare adjustment for the purpose of making recommendations to the CE-in-Council, the Administration takes into account a basket of factors known as the MBOF approach as endorsed by CE-in-Council in 2000, 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) quantity and quality of service provided.

3. On top of the above arrangement, any return achieved by a franchised bus operator exceeding the rate of return on average net fixed asset ("ANFA")[1] of 13% would be shared equally on a 50/50 basis between the operator and passengers. This is a pledge by bus operators to moderate fare increase or grant fare concessions in future up to a value of 50% of the return exceeding 13%. This triggering point of 13% was established in 2000 based on the historical average rate of return on ANFA of the franchised bus industry between 1990 and 1999.

4. The Administration undertook to review the MBOF approach in five years' time to take into account changes in the operating and economic environment.

Review of the MBOF Approach

5. There have been suggestions that the MBOF approach could be modified to enhance the responsiveness and objectivity of the bus fare adjustment process. Against this background, we have conducted a review of the basis for considering bus fare adjustments.

[1] Both the net profits to shareholders (i.e. profit after taxation) and the borrowing costs incurred by the operator are included in calculating an operator's return. ANFA is the average value of assets at historical cost net of depreciation, except for land where no depreciation is charged. Under Section 12A of the PBSO, a franchisee is required to provide a Forward Planning Programme (FPP) each year, covering amongst others, its plan to acquire additional assets. The FPP has to be agreed by the Commissioner for Transport. This could safeguard against any unwarranted inflation of operators' asset.

Modifications to the MBOF Approach

6. The main objectives of the modifications to the MBOF approach are to facilitate adjustment of bus fares upwards and downwards to provide greater responsiveness to prevailing economic conditions, and to improve objectivity of fare adjustment process while maintaining the flexibility to consider the factors embodied in the MBOF approach.

7. To achieve the above goals, we will build on the existing MBOF approach by retaining all factors outlined in paragraph 2 above and introduce a new fare adjustment formula and several new objective benchmarks for fare adjustment assessment. The CE-in-Council will continue to retain the ultimate power in determining bus fares as provided in the PBSO to consider and balance all relevant factors including public affordability and the bus operators' financial viability.

Improve Objectivity and Allow Fares to Go Upward and Downward

8. We will introduce in the existing MBOF approach the following formula to enable upward and downward bus fare adjustments in accordance with the prevailing economic conditions and to enhance the objectivity of bus fare adjustment –

> Supportable Fare Adjustment Rate ("SFAR")
> = 0.5 x change in Wage Index + 0.5 x change in Composite Consumer Price Index ("CCPI") – 0.5 x Productivity Gain

This formula will apply with effect from 10 January 2006 and thereafter from the date of the last fare adjustment.

(a) Wage Index

9. This formula can reflect the rate of change in operating costs for the franchised bus industry. Staff cost constitutes about 50% of the operating costs of franchised bus operators. In the formula, staff cost is reflected by the nominal wage index for the transport sector published by Census and Statistical Department ("C&SD"). The index is a reasonable indicator of the change in staff cost of the bus industry since employees of motor buses constitute the largest group (about 20%) of the workforce of the transport sector covered by this index.

10. Using the wage index to measure the change in staff cost has the merit of improving objectivity because bus operators would not be able to manipulate the SFAR through adjusting the wage of their staff. For instance, under the formula, the effect of a pay rise by the bus operator will not directly result in a supportable fare increase.

(b) <u>Composite Consumer Price Index</u>

11. The remaining cost components of bus operators are to be reflected by CCPI which can serve a dual purpose. On the one hand, CCPI is an easily understood and publicly available indicator to reflect the overall price level change of goods and services. It thus provides a more transparent and objective basis to facilitate public understanding of the case for bus fare adjustments. On the other hand, given that CCPI also reflects deflation and inflation situation of the economy, inclusion of CCPI in the formula will provide a basis for upward or downward fare adjustment in response to prevailing economic conditions.

12. The introduction of a fare adjustment formula as an additional factor is an improvement to the existing MBOF approach because with the wage index and CCPI incorporated into the formula, fare reduction can then be triggered by downward change of the two indices in the future. Furthermore, the wage index and CCPI are open data published by C&SD on a quarterly and monthly basis respectively. Adopting these two indices would minimise reliance on information provided by the bus operators.

(c) <u>Productivity Gain</u>

13. To incentivise franchised bus operators to improve efficiency and productivity, the formula will include a productivity gain element which measures the percentage change in output relative to the percentage change in input. Our approach is to measure the output of the bus industry by total fare and non-fare revenue[2] and the input by total operating cost. The industry-wide productivity gain is derived by using the ratio of total fare and non-fare revenue to total operating costs. In order to assess the change in productivity of the bus industry during a sufficiently long period of time, we have used the data from a 10-year period, i.e. from 1995 to 2004.

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[2] Under the existing practice, in measuring the rate of return of a franchised bus operator, both fare revenue and non-fare revenue will be taken into account. Non-fare revenue is included because it is related to the bus operation. The major item of non-fare revenue is advertising income (bus body advertising and bus shelter advertising).

14. Comparing the ratio of total fare and non-fare revenue to total operating costs based on the data from 2000 to 2004 with the corresponding value from 1995 to 1999, the productivity gain thus calculated is 0.51% per annum ("p.a."). In the fare adjustment formula, half of the annual productivity gain will be shared with passengers. In this way, a negative value of 0.3% p.a. (i.e. 0.5 x 0.51% p.a.) has been pre-determined and built into the formula. This value will be fixed for the coming three years until the review of the formula. This element will have the effect of moderating fare increase by 0.3% p.a. when the changes in CCPI and Wage Index point to an upward fare adjustment. Similarly, this will further reduce the fares by 0.3% p.a. if the changes in CCPI and Wage Index give a downward fare adjustment. Taking into account the fixed value of 0.3% p.a. for the productivity gain element, the resultant SFAR formula for the next three years will be -

0.5 x Change in Wage Index + 0.5 x Change in CCPI – 0.3% p.a.

Determining Bus Fare Adjustment

(a) Outcome of the Formula

15. The inclusion of the formula will provide a more objective and responsive starting point for considering bus fare adjustments. We will use the outcome of the formula as the reference indicator in considering whether fare adjustment rate is supportable and justifiable at a given juncture. The formula will not operate as an automatic determinant of fare adjustment outcome. The CE-in-Council will continue to retain the ultimate control in determining bus fares as currently provided in the PBSO to ensure all relevant factors under the MBOF approach (including those as set out in paragraph 2 above) will continue to be considered.

(b) Factors under the MBOF Approach

(i) Public Acceptability and Affordability

16. Under the existing MBOF approach, we make reference to the changes in CCPI when considering public acceptability of the rate of bus fare adjustment. While the CCPI aggregates expenditure pattern of 90% of the households, public affordability is also affected by the income of the general public. Under the new arrangement, we will examine the magnitude of change in median household income, as an additional reference indicator to CCPI, to gauge more comprehensively public affordability.

(ii) Financial Viability and Performance of Bus Operators

17. We will continue the existing practice for bus industry of not setting a guaranteed minimum level nor a ceiling of rate of return. Neither will we prescribe a specific rate of reasonable return for all bus operators given circumstances and operating conditions vary among them.

18. In assessing the reasonable rate of return to bus operators, we will change the reference from historical rate of return on ANFA to WACC of the bus industry. The WACC is the average cost of debt and equity weighted by their respective proportion in the bus industry as a whole[3]. The WACC is derived based on an established and widely used formula which takes into account financial data of the market reflecting the cost of debt and equity. The WACC calculated for the bus industry is 9.7%. As compared with the historical average rate of return on ANFA, the WACC can better reflect the prevailing economic situation and operating environment of the bus industry.

19. To assess the financial performance of the bus operator, our consideration is to ensure bus companies will have sound financial capability in providing efficient and quality public bus services. Following the established practice under the MBOF approach, we will consider the changes in operating costs and revenue since the last fare adjustment as well as the forecast of operating costs and revenue to have a clear and fair assessment of the operator's financial performance.

20. Taking into account the changes in operating costs and revenue since last fare adjustment not only serves to track the historical change in rate of return but will also enable the Administration to consider any prevailing cost factors, e.g. sustained and significant fuel cost hike, that might have serious impact on the overall operating costs and possibly affect the rate of return of individual bus operators. This is important as it can obviate the need to incorporate each and every cost component of bus operation into the fare adjustment formula, thus without giving bus operators a convenient avenue to pass directly all its operating costs to bus passengers through the formula.

(iii) Quality and Quantity of Services

21. We will continue, as now being practised under the MBOF approach, to monitor the quality and quantity of service and examine this

[3] The WACC can be regarded as the expected rate of return of the investors in general for the bus industry under the prevailing economic conditions.

impact on the return of the bus operator. In this regard, we will take into account objective indicators including the findings of passenger satisfaction surveys and site surveys, complaint figures and accident rates, to see whether the quality and quantity of service have affected the patronage and in turn the rate of return on ANFA of the bus operator. As pointed out in paragraph 18 above, we will make reference to WACC in assessing the reasonable rate of return of the operators.

(d) Balancing All the Relevant Factors

22. The outcome of the formula will serve as a starting point for the fare adjustment process. Having balanced all relevant factors mentioned in paragraphs 15 to 21, the Administration will consider whether there is a need to make adjustment to the SFAR. If so, the extent of the adjustment will be considered on the basis of the merit of the case.

23. The Administration will also continue the existing practice of consulting the Transport Advisory Committee ("TAC") and the Legislative Council ("LegCo") Panel on Transport ("Transport Panel") before submitting its recommendation on the rate of fare adjustment to the CE-in-Council. The Administration will explain to the public and LegCo Members on how the approved rate of bus fare adjustment is arrived at by considering the set of objective indicators during the process, and how the approved rate of fare adjustment will affect the financial performance of the bus operators concerned.

Passenger Reward Arrangement

24. Under the MBOF approach, there is an existing arrangement whereby any return achieved by a bus operator on top of 13% rate of return on ANFA would be shared between the operator and passengers to relieve the pressure for future fare increase and to facilitate the offer of bus fare concessions.

25. To better reflect the changes in capital market environment, we will lower the existing triggering point for sharing of return with passengers from 13% return on ANFA to 9.7%. The revised triggering point is based on the WACC calculated for the bus industry in the light of the prevailing economic conditions.

26. To enhance transparency, we will introduce measures to enable the public to monitor the use of passenger reward balance. The franchised bus operators will publish the passenger reward balance accumulated and their

plan to utilise the amount in their booklet of “Fuller Disclosure” on an annual basis[4]. For the amount up to the equivalent of 1% of its annual revenue for the last accounting period in the passenger reward balance, operators will be given the flexibility to decide, in consultation with the Administration, when to use it for reducing the magnitude of fare increase required in future, or for providing fare concessions. Operators will need to use any amount in the passenger reward balance exceeding the equivalent of 1% of the annual revenue for provision of fare concessions within 12 months since the disclosure of the passenger reward balance accumulated.

Procedure of Bus Fare Increase and Reduction

27. C&SD publishes, on a monthly basis, the CCPI, and on a quarterly basis, the wage index and median household income. A negative value of 0.3% p.a. representing the productivity gain element will be pre-determined for three years and built into the formula. With the above publicly known data, any changes in the outcome of the formula is open to the public and can be easily monitored.

28. The Administration will monitor the supportable fare change by applying the fare adjustment formula on a quarterly basis and will consider initiating a downward fare adjustment after having considered the outcome of the formula and all relevant factors under the MBOF approach.

29. As regards fare increase, it will be up to the bus operators to apply as at present if they see a need for upward adjustment of bus fares. The power to determine the fare adjustment applications remains with the CE-in-Council. In considering both upward and downward fare adjustment, we will consider the changes of the various indices included in the formula since the effective date of implementation of the new arrangement and consider other factors under the MBOF approach. Processing of any fare adjustment is envisaged to take about six months.

30. To avoid frequent fluctuation in bus fares which will cause inconvenience to passengers, fare change, be it upward or downward adjustment, will only be implemented if it amounts to 10 cents or more per bus trip on average. Any adjustments lower than this level will be difficult to implement.

[4] This booklet will be published within five months after the end of an accounting year of the respective bus operators.

Benefits of the Improvement Measures

31. Adopting the improvement measures will bring the following benefits –

(a) fare levels would be able to fall or rise in future to better reflect changes in economic circumstances and the Government can initiate fare reduction having regard to the prevailing economic conditions;

(b) the introduction of productivity gain element allows passengers to share the benefit arising from productivity improvement of bus operators through increasing the magnitude of fare reduction or moderating fare increase when one is required. It also provides incentive for an individual operator to outperform the industry-wide productivity improvement;

(c) the design of the formula, which does not include fluctuating and volatile cost elements, can avoid as far as practicable passengers having to bear directly the impact of drastic changes in operating costs without reference to the impact of such changes on the operators and the effect of mitigation measures taken by the bus companies;

(d) the modified approach embodies objective indicators which could enhance objectivity of the basis for initiating the fare adjustment process and reduce reliance on information provided by bus operators;

(e) the reference to changes in median household income and the WACC of the bus industry will strike a balance between public affordability and bus operation; and

(f) the lowering of triggering point for activating the passenger reward arrangement from 13% return on ANFA to 9.7% is more in line with the prevailing economic conditions.

Effective Date of the New Arrangement

32. We will implement the new bus fare adjustment arrangement on 10 January 2006. The new arrangement will be applied to all six franchisees on the same day. That said, all factors under the existing MBOF approach

would be applied on a continual basis with reference to the date of last fare adjustment, or commencement of operation for bus operators which have not adjusted fares before. For the new elements of the new arrangement, i.e. introduction of the fare adjustment formula as an additional factor, the making reference to median household income and WACC, the lowering of the triggering point for sharing of return from 13% return on ANFA to 9.7%, and the passenger reward arrangement, will be applied from 10 January 2006 onwards.

Future Review

33. We will review the new arrangements in three years' time, as it is a new approach which warrants a closer monitoring of its effectiveness.

IMPLICATIONS OF THE NEW ARRANGEMENT

34. The new arrangement has no civil service, environmental, financial or productivity implications. The economic and sustainability implications of the new arrangement are set out in Annex.

PUBLIC CONSULTATION

35. We have fully engaged the bus operators in formulating the new arrangement and they generally support the new fare adjustment arrangement and its review in three years' time. We also consulted the Transport Panel on 17 and 25 November 2005 and 16 December 2005 and the TAC on 22 November 2005. LegCo and TAC Members were supportive of the new fare adjustment arrangement.

PUBLICITY

36. We will issue a press release, and a spokesman will be made available to answer press enquiries.

ENQUIRIES

37. Enquiries concerning the brief should be directed to the following

officer-

Miss Angela Lee
Principal Assistant Secretary for the Environment, Transport and Works
Tel No: 2189 2081

Environment, Transport and Works Bureau
January 2006

Annex

ECONOMIC IMPLICATIONS

Franchised buses account for over one-third of the public transport passenger flow in Hong Kong, and their services is an important determinant of cross-district labour movements and in turn a series of economic activities. A transparent and objective regulatory framework that ensures affordable high-quality franchised bus services would be conducive to higher labour mobility and more balanced economic growth in Hong Kong.

2. Under the new fare adjustment arrangement, reference to the changes in CCPI and nominal wage index for the transport sector could help ensure that bus fares are responsive to the change in operating costs of the franchised bus industry. Also, median household income is used as an additional reference to gauge affordability in bus fares adjustment and the bus fares could thus better reflect the prevailing economic conditions. The inclusion of 50/50 sharing of productivity gain in the formula would benefit the consumers as a whole.

SUSTAINABILITY IMPLICATIONS

3. As far as sustainability implications are concerned, the new arrangement would improve the transparency and objectivity of the existing fare adjustment mechanism for franchised buses, and allow bus fares to be adjusted more responsively to the prevailing economic conditions. Nevertheless, particular attention should be paid to the possible impact on the low-income population in considering fare adjustments during a period of inflation.

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