Islands District Council
Traffic and Transport Committee
Paper T&TC 72/2016

Special Helping Measures for six major outlying island ferry routes for the next three year licence period 2017-20

Purpose

This paper briefs Members on the arrangement of extending the licence of the six major outlying island ferry routes[1] for three years.

Background

2. It is the Government's established policy that public transport services should be run by the private sector in accordance with commercial principles to enhance efficiency and cost-effectiveness. There is no direct subsidy from the Government for public transport services save for the six major outlying island ferry routes. The Government provides Special Helping Measures ("SHM") to these routes, because there is basically no alternative to the ferry services available as a means of public transport[2], and short of the SHM, the ferry services cannot be maintained without periodic hefty fare increases. The SHM maintains the financial viability of the ferry services and alleviates the burden of fare increase on passengers.

3. The SHM was first launched in 2011 with funding approval from the Finance Committee ("FC") of the Legislative Council ("LegCo") on a three-year cycle, tying in with the three-year ferry service licence period. Subsidies are made through reimbursement of certain expenses associated

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[1] Routes operated by the New World First Ferry Services Limited :
(1) "Central – Cheung Chau";
(2) "Inter-islands" between Peng Chau, Mui Wo, Chi Ma Wan and Cheung Chau ; and
(3) "Central – Mui Wo" routes.

Routes operated by the Hong Kong & Kowloon Ferry Holdings Limited's three subsidiaries :
(4) "Central – Peng Chau";
(5) "Central – Yung Shue Wan"; and
(6) "Central – Sok Kwu Wan" routes.

[2] Only Mui Wo is also linked by an external road network, but its cross-district land-based public transport services are very limited.

with the operation of the ferry services. Reimbursement is arranged according to actual expenses, to ensure that the operators would continue to drive operating efficiency and that public funds are properly used. In accordance with the established policy mentioned in paragraph 2 and for prudent use of public fund, fuel and staff costs are not subsidised. For the current licence period from mid-2014 to mid-2017, a commitment of around $190 million was approved by the FC in 2013 to implement the second round of SHM for the six major outlying island ferry routes, also for a period of three years. Details are set out at **Annex A**.

4. Earlier this year, the two incumbent operators of the six major outlying island ferry routes (i.e. New World First Ferry Services Limited ("NWFF") and three subsidiaries of Hong Kong and Kowloon Ferry Holdings Limited ("HKK")) approached the Transport Department ("TD") for applying for licence extension. The Government consulted the LegCo Panel on Transport ("the Panel") on this in April 2016. The Panel noted the operating difficulty of ferry service, and that there were not many service providers available in the market. The Panel also noted the experience that there had been no new service provider submitting bids[3] when the Government conducted the open tender for the operating right of the ferries. Taking these into account, to ensure a smooth continuation of ferry service when the current licence period would expire in mid-2017, the Panel supported the Government to enter into direct negotiation with the two operators to discuss the terms of licence extension. For details, please refer to LC Paper No. CB(4)831/15-16(03).

Next Three-year Licence Period

5. The negotiation between the Government and the ferry operators has been completed. The arrangements for the licence extension are set out in paragraphs 6 to 16 below.

Continued provision and enhancement of SHM

6. Based on the revenue and cost situation in the first two years of the current licence period and the industry outlook (including the projections of patronage, oil price, wages and other operating costs in the coming three-year licence period), we have conducted an assessment on

[3] When the TD conducted the open tenders for the six major outlying island routes in 2007/08 and 2011, only NWFF and subsidiaries of HKK submitted bids.

the financial performance of the six outlying island ferry routes in the next licence period. The assessment results show that without SHM and fare increase, NWFF and HKK would suffer from a significant financial loss in the next three-year licence period 2017-20. To achieve breakeven alone, a substantial fare increase of around 30% would be needed for the two operators. To moderate the fare increase, there is clearly a case for continued provision of SHM and the subsidy amount will also need to be suitably adjusted upwards due to the increase in costs.

7. We have examined the scope of the SHM. To encourage the operators to introduce new vessels or improve services, facilities or equipment, we now propose the addition of a new item, to reimburse the depreciation expenses of the abovementioned capital investments. The depreciation costs should only be reimbursed by half, having considered that the ownership of assets with depreciation cost subsidy would rest with the operators. Based on the current information, the operators have already planned to introduce two new vessels and a series of ferry fleet upgrading projects in the next licence period (such as replacement of air-conditioning and ventilation systems and refurbishment of passenger cabins/washrooms).

Fare Adjustment

8. SHM maintains the financial viability of the ferry services and alleviates the burden of fare increase on passengers. Despite the continued provision of SHM by the Government, the ferry operators express that there has been pressure for fare increase, owing to the significant increase in operating cost, particularly the significant pay rise of ferry crew members in recent years. Therefore, when the two ferry operators applied for licence extension, the two ferry operators requested for a fare increase of about 10% upon the commencement of the new licence period.

9. We appreciate outlying island residents' concerns about the fares of outlying island ferry services. At the same time, the fundamental policy consideration of the SHM is that ferry passengers, as in the case of passengers of other public transport modes, should shoulder a fair share of fare burden, and the burden of fare increase is alleviated through the SHM. The ferry operators have submitted financial information and data on the operating costs in the wake of fuel cost rebound pressure, significant increase of staff remuneration expenses and ferry fleet upgrading. The TD has carefully examined these information and data. The TD has also taken into account the subsidy amount expected in the

coming three years (see paragraph 11 below), with a view to alleviating the burden of fare increase on passengers as far as possible.

10. After careful consideration, the Government intends to approve an average fare increase rate of around 4%[4] for the six routes, which will take effect on commencement of the new licence period. In other words, the new fares will take effect gradually[5] along the commencement date of the licence period of the six routes in mid-2017, which would be three years from the last fare increase in 2014 (fare increase rates were around 5% to 6% at that time). The proposed fare increase rate is lower than the projected cumulative increase in the Composite Consumer Price Index (7.4%) in the current licence period (i.e. during the period from July 2014 to June 2017).

<u>SHM amount</u>

11. Considering the financial projections of the ferry operators, the SHM subsidy and an average fare increase rate of around 4%, the funding required for the SHM for the next three-year licence period would be around $340 million. In line with the practice in the current licence period, a buffer of 20% would be budgeted for contingency, and therefore bringing the SHM amount to some $410 million.

12. The SHM amounts to around $190 million (with the 20% contingency funding included) for the current licence period. The substantial increase in the SHM sum is attributable mainly to the introduction of the new item of reimbursing half of the depreciation expense under SHM, the substantial increase in repair and maintenance cost, the increase in other costs that could be reimbursed under SHM, and the increase in contingency provision in proportion to the total, now expanded, SHM amount required. In other words, apart from creating

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[4] Having considered the different patronage and operating mode of the six routes, as well as the different financial situation of the two ferry operators, the Government intends to approve an overall average fare increase of around 3.9% for "Central – Cheung Chau", "Inter-islands" and "Central – Mui Wo" routes operated by NWFF while the overall average fare increase rate for the "Central – Peng Chau", "Central – Yung Shue Wan" and "Central – Sok Kwu Wan" routes operated by HKK is around 4%. Details are in **<u>Annex B</u>**.

[5] Except for the "Central – Mui Wo" route of which the licence after extension will take effect from 1 April 2017, the licences of the other five routes will be effective from 1 July 2017 after extension. The licence duration of the six routes are of three years.

the new depreciation expense item, this increase in subsidy mainly seeks to meet escalating operating costs so as to alleviate the fare burden on passengers. Details are at **Annex C**. SHM reimbursement is subject to actual usage and invoices would be carefully verified by the TD. Therefore, increasing the maximum amount would not lead to abuse.

Projected Profit Margin

13. The actual profit margin of the two ferry operators for the first three-year licence period (2011-2014) was around 7%. The actual profit margin for the first 18 months of the current licence period (after sharing with passengers the "windfall profit") was around 7.5% and 13.5% for NWFF and HKK respectively[6].

14. We have projected the various major items of operating costs (including fuel, staff cost, repairs and depreciation etc.) and farebox revenue, non-farebox revenue and SHM for the two ferry operators in the next three-year licence period. Having regard to these projections, the projected profit margin for NWFF is around 6.0%, while that for HKK is around 6.2%, which are lower than the actual profit margin in the first licence period[7] and that in the first 18 months of the current licence period (see paragraph 13 above). The projected profit margins are overall projection for the entire three-year licence period rather than on an annual basis. In projecting the profit margins, we have already worked out the projected expenses of the various key operating costs such as fuel. We have also taken into consideration the impact of SHM and the fare increase starting from the commencement of the licence in 2017 (see paragraph 10 above) on operation.

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6 In the first 18 operating months of the current licence period, the two operators benefitted from oil price adjustment and recorded respectable profits exceeding the original projections. After negotiation between the Government and the operators, the two ferry operators agreed to share "windfall profit" with passengers on a 50:50 basis through a time-limited and one-off fare concession. The amount of fare concession concerned is around $22 million. The fare concession is to reward to passengers the entire amount attributed to the profit sharing, under a 50:50 basis. The two ferry operators both offered an overall fare concession of around 10-20% off for around half a year for the various routes.

7 The profit margin of NWFF and HKK in the first licence period (2011-14) was 7% and 8.1% respectively.

15. The financial consultant commissioned by the Government considers that the above projected profit margins are reasonable, noting that the possible volatility of oil price, the difficult operating environment of ferries in general, and the sustained need for the operators to improve remuneration package for its staff in order to attract new blood to the industry etc. It should be noted that, the above projected profit margins are only for drawing up the implementation details of the SHM during the licence extension, processing fare increase applications and working out the profit-sharing mechanism for the next licence period (see paragraph 16 below). **The projections concerned are neither guaranteed profit nor profitability caps**. Instead, they are a projection tool for assessing the financial viability of the operations.

Profit-sharing Mechanism

16. Under the profit-sharing mechanism established in the last mid-term review (please see LC Paper No. CB(4)831/15-16(03) for details), the operators would share any "windfall profit" (i.e. the profit exceeding the projected profit margin at the time of licence extension; also see paragraph 13) with passengers on a 50:50 basis through offering fare concession. The same profit-sharing mechanism will be applicable to the next licence period 2017-20, which will share the "windfall profit" earned in the first half of the licence period with passengers on a 50:50 basis in the second half of the licence period, while the "windfall profit" earned in the second half of the licence period will be shared with passengers on a 50:50 basis in the next licence period.

Maintaining the Long-term Financial Viability of Outlying Island Ferry Service

17. The Government first introduced the SHM arrangement for the six major outlying island ferry routes in 2011. The next three-year licence period (i.e. 2017-2020) is the first time where the Government subsidises operators' depreciation expense to encourage the operators to introduce new vessels and upgrade facilities or equipment, and the Government will also formally incorporate the profit-sharing mechanism into the terms of licence extension of the ferry services. It will take time to see what the actual effectiveness of the above new arrangements will be in enhancing ferry service and maintaining the long-term financial

viability of ferry service. We will look into this in the next mid-term review (in the first half of 2019). At that time, the Government will review in one go whether the currently proposed SHM would be the most desirable long-term operation model for maintaining the service quality and financial viability of ferry services.

18. The Ferry Service Ordinance (Cap. 104) stipulates that a licence period for ferry service should be three years at the maximum. We are of the view that this requirement hampers the operators' capability for longer-term planning and investment for ferry services. We will take the opportunity of the next mid-term review to explore extending the effective period of a licence, through legislative amendments.

19. In 2013, the Government proposed taking forward the construction of additional floors at Central Piers Nos. 4, 5 and 6, to provide shop rental income to cross-subsidise the operation of the six routes. When the proposal was submitted to the Public Works Sub-committee under the FC for consideration, the Sub-committee raised various concerns over the rental income and operations and management issues[8], and voted down the proposal of upgrading the construction project to Category A. As reported to the Panel in April this year (see LC Paper No. CB(4)831/15-16(03)), we were reconsidering in detail whether it is desirable to subsidise the operation of the six routes by the rental income generated under this proposal.

20. On reviewing this proposal, our consultant points out that for this model of rental cross-subsidising ferry operations to work, an agency would need to be engaged by the Government to operate and manage the retail shops of those three piers on behalf of the various ferry operators, in order to avoid possible conflict of interest and to achieve economy of scale. Given the construction cost involved of such proposal (estimated to be around $610 million in 2013), the uncertainty of rental income, and the complex contractual relationship among stakeholders (namely the Government, ferry operators, the lease agency as well as shop tenants), and that the fees to be charged by the agency would reduce the eventual rental income for the cross-subsidy purpose, preliminarily, we are of the view that this proposal may not be the most feasible and desirable model.

21. Separately, there are views that the Government should procure

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[8] Members' major concerns included opining that the Government underestimated the projection of rental revenue, and should work out a business model of the piers that could maximise rental income. There were also suggestions that the Government should reconsider the design of the exterior appearance of the piers.

vessels for the operators to reduce their operating costs, as ferry operators have been facing a sustained and difficult operating environment. It is the Government's established policy that public transport services should be run by the private sector in accordance with commercial principles to enhance efficiency and cost-effectiveness. This proposal deviates from that established public transport policy. However, as stated in paragraph 7 above, to encourage operators to introduce new vessels or improve services, facilities or equipment, the Government now proposes the introduction of a new item in the next three-year licence period so as to reimburse half of the depreciation expenses of the abovementioned capital investment. Accordingly, two new vessels will be introduced to the fleet. In fact, the major pressure faced by the ferry operators are from the continuously escalating operating expenses, of which around 70% are attributable to fuel and staff costs. Even if the Government were to procure vessels for the operators to reduce operating cost, this would only lower the expenditure arising from capital investment. It could not solve the problem of recurrent deficit in daily operation. Therefore, SHM would still need to be maintained.

22. Another similar idea is for the Government to procure and own ferries, and to outsource the service. If this would be pursued, ferry service will in effect become a public service. If implemented, it will definitely involve a large sum of public money. It will also be difficult to ensure cost effectiveness and may even bring about far-reaching implications for the public transport policy.

<u>The eight remaining outlying island ferry routes</u>

23. Currently, apart from the six major outlying island ferry routes, there are eight other outlying island ferry routes[9]. There are views that the SHM should be expanded to these eight outlying island ferry routes. We will examine this matter. Specifically, we will consider a whole host of factors, including the principle of prudent use of public money, whether there are any alternative public transport service of each of the eight routes, the operating environment of each of the eight routes (for

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[9] The eight other outlying island ferry routes include:
(1) "Aberdeen – Cheung Chau";
(2) "Aberdeen – Yung Shue Wan via Pak Kok Tsuen";
(3) "Aberdeen – Sok Kwu Wan via Mo Tat";
(4) "Tuen Mun – Tung Chung – Sha Lo Wan – Tai O";
(5) "Discovery Bay – Central"
(6) "Discovery Bay – Mui Wo";
(7) "Ma Wan - Central"; and
(8) "Ma Wan – Tsuen Wan".

example, some of the routes were launched in support of the new residential development projects at that time) and the different financial situation (some of the routes are suffering financial loss but there are routes that are relatively financially manageable for the time being) and patronage of the eight routes etc. The current data on these issues are at **Annex D**. The profit-sharing mechanism has become the terms of licence renewal for 2017-20 for the six major outlying island ferry routes. Whether it should be applicable to the other eight routes needs to be studied. Besides, the duration of the licence periods of those eight routes are not the same (the existing licence periods range from one to three years; details are in **Annex D**). Whether the future licence periods should be rationalised or unified also needs to be studied. When the Government makes a decision on the long-term operation model of the six major outlying island ferry routes in the first half of 2019, it will decide in one go whether and how the long-term operation model to be selected at that time should be applicable to those eight routes. We will then consult the LegCo and the Islands District Council.

Way forward

24. Members are invited to note the above licence extension arrangements for the six major outlying island ferry routes outlined in paragraphs 6 – 16 above. Subject to Members' views, we plan to seek funding from the LegCo FC in early 2017. TD will approve the extension of the current licences of the six routes for three years in accordance with section 29(2) of the Ferry Services Ordinance.

25. Moreover, NWFF and HKK have submitted their service improvement proposals of their individual ferry routes for their next 3-year licences to the Transport Department (TD). The TD is examining the details of the proposals and will consult the Islands District Council in December 2016.

Transport Department
November 2016