Islands District Council
Paper No. IDC 37/2016
Mid-term Review for Ferry Services of the Current Licence Period

PURPOSE

This paper reports the outcome of the mid-term review on the Government's provision of Special Helping Measures ("SHM") to the ferry routes[1] for the current licence period since 2014 ("Mid-term Review").

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 SHM are provided to these routes by the Government because there is basically no alternative to the ferry services as a means of public transport[2], and short of the SHM, the ferry services cannot be maintained without periodic hefty fare increases. SHM maintains the financial viability of the ferry services and alleviates the burden of fare increase on passengers.

3. The SHM were 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 validity of a ferry service licence. Subsidies are made through reimbursement of certain expenses

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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 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".

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

associated with the operation of the ferry services. Reimbursement is subject to financial caps, pre-agreed by the Government and the operators. 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. As a matter of policy, fuel and staff costs are not covered by the SHM. For the licence period from mid-2011 to mid-2014, reimbursement made under the SHM was about $112 million, covering about 10% of the total operating costs of the six major outlying island ferry routes.

4. 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 provide 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**.

OUTCOME OF THE MID-TERM REVIEW

(A) Purpose of the Mid-term Review and Effectiveness of the SHM

5. In 2010, the Government consulted the LegCo Panel on Transport the implementation of the SHM, and undertook to conduct a mid-term review during the three-year licence period to monitor the proper spending of public funds and consider lowering ferry fares when operating costs are projected to be reduced.

6. For the 2011-14 licence period, with the assistance of the SHM, the weekday adult single journey and monthly ticket fares of the six major outlying ferry routes were increased by about 10% and 7% respectively. For the 2014-17 licence period, the weekday adult single journey and monthly ticket fares of the six routes were increased by about 5% to 6% respectively in mid-2014. Without the SHM, the rates for the two fare increases would have been as high as about 20% to balance the books of the operators. Judging from the above, the SHM have achieved the intended purpose of ensuring the financial viability of the ferry services while lowering the fare increase rates and alleviating the burden on passengers.

7. We have assessed the operational performance of the six major outlying island ferry routes by examining the complaint figures, passenger survey results and operational returns submitted by the operators. Our analysis shows that the ferry services are overall

satisfactory (details are set out at **Annex B**).

(B) Financial Performance

8. First launched in the 2011-14 licence period, the SHM not only helped avoid hefty fare increases but also maintained reasonable profits[3] for the operators. In view of this, the Government adopted a similar approach in 2014 when planning how the SHM should be implemented for the current three-year licence period.

9. Upon consultation with the LegCo Transport Panel and approval by the Executive Council, the Government extended the licences to the two operators in 2014 through direct negotiation. To facilitate the setting of reasonable financial caps for reimbursable items under the SHM and the processing of fare increase applications, the Government and the two operators made assumptions for the various major operating cost items (including fuel, staff, repair and maintenance, depreciation, etc.), fare box revenue and non-fare box revenue for the three-year licence period. Based on these assumptions, the projected profit margin for the New World First Ferry Services Limited (NWFF) was 5.4%, while that for the subsidiaries of the Hong Kong and Kowloon Ferry Holdings Limited (HKK) was 3.5%. The projected profit margins were overall projection for the entire three-year licence period rather than on an annual basis. In working out the projected profit margins, we made estimates of the various major operating cost items including fuel, and also took account of the impact of the SHM and the 2014 fare increase (of about 5% to 6%) on the operation of ferry services. We had different projected profit margins for the two operators because of their different operating scale and environment. It should be noted that the projected profit margins at the beginning of the three-year licence period only served as references to facilitate the Government in drawing up the implementation details of the SHM and processing fare increase applications. They were neither guaranteed profit nor profitability caps. In fact, we have all along encouraged operators to strive to achieve efficiency gain and effective management, so as to achieve a higher profit with a view to alleviating pressure for fare increase.

[3] In the 2011-14 licence period, the NWFF and HKK achieved an overall profit margin of 7% and 8.1% respectively with the SHM subsidy and a fare increase of around 10%.

10. Given that the implementation of SHM in the previous licence period (2011-14) achieved the intended purpose of maintaining ferry services while alleviating the pressure for fare increase, and that there were no signs indicating possible significant changes to the estimated operating costs and revenue in future (during 2014-17), the Government had no specific discussion or agreement with the operators on what the arrangement should be if the projected profit margins would in time show to be wide of the mark.

11. The actual operational data for the first 18 operating months of the current licence period (i.e. mid-2014 to the end of 2015) is now available. The data shows that the two operators' actual profit to date significantly increased over the projected profit margins projected in 2014, largely attributable to the deep fall in oil prices[4]. As the NWFF had hedged the oil prices, the amount of profit exceeding the original projected profit margin ("windfall profit") it enjoyed was therefore relatively less. Even so, the profit margin of the NWFF was about 9.8% for the first 18 operating months of the current licence period. The HKK had not hedged oil prices and thus benefited more from the oil price fall and earned a profit margin of about 21.4% for the same period. (These profit margins only concern the first 18 months of the three-year licence period from 2014 to 2017, and are not the overall profit margins for the entire three-year period. The profit margins of the remaining 18 months of the licence period are still subject to uncertainties in future. Therefore the eventual overall profit margins for the three-year licence period is not known at this stage, and it should not be projected simply by making reference to those achieved for the first 18 months.)

(C) Profit-Sharing Mechanism

12. It can be seen that during the first 18 operating months of the

[4] Oil price dropped by over 60% during the first 18 operating months, i.e., from around US$103 per barrel (West Texas Intermediate crude oil price) in July 2014 to around US$37 per barrel in December 2015.

current licence period, the NWFF and HKK achieved profit margins that are, respectively, 4.4 percentage points and 17.9 percentage points higher than their original projected profit margins. In the light of this and considering that the two operators are subsidised under the SHM, and that there was also a fare increase (of about 5% to 6%) at the beginning of the licence period, we see the need for the operators to share their windfall profit with passengers.

13. While the oil price adjustment has largely contributed to the windfall profit (around 60%), efforts made by the operators in increasing their non-fare box revenue and achieving efficiency gains are also contributing factors (accounting for some 40%[5] of the windfall profit). Furthermore, to give operators an incentive to continue to operate ferry services in the most cost-effective and efficient way, and to generate as much non-fare box revenue as possible, there are grounds for ferry operators to keep a considerable part of the windfall profit.

14. As mentioned in paragraph 10 above, when the current licence period commenced in 2014, the Government had no specific discussion or agreement with the operators on what the arrangement should be if the projected profit margins would in time show to be wide of the mark. **After several rounds of negotiations between the Government and the two ferry operators, the latter agreed to share the windfall profit with passengers through an one-off and time-limited fare concession on a 50:50 basis.** The amount for offering fare concession for the six major outlying island ferry routes is around $22 million. Since NWFF hedged oil price, its windfall profit and hence the amount for sharing with passengers is relatively lower. The arrangement for ferry operators and passengers to share the windfall profit on a 50:50 basis is a reasonable and practical approach, which is comparable to the existing passenger reward arrangement for franchised buses[6].

15. Under the fare concession arrangement, the windfall profit to be shared out in half will be rewarded entirely to passengers. It is expected

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[5] The some 40% windfall profit is attributed to higher-than-expected patronage and hence higher fare box revenue; higher-than-expected non-fare box revenue (e.g. rental revenue from subletting ferry pier areas as event venues and retail shops); and lower-than-expected maintenance cost.

[6] Under such arrangement, any return achieved by a franchised bus operator exceeding the rate of return agreed (that rate of return is currently 9.7%) would be shared equally between the operator and passengers.

that both ferry operators will be able to offer, for several months, an overall discount rate of around 10% approximately on monthly ticket and weekday single journey fares (such concession may not be applicable to Sunday and holiday single journey fares). It is expected that the fare concession will commence with effect from July 2016. The operators will work out and announce the details not before long. It is worth noting that since the amounts of windfall profit for the two operators are not the same, the discounts offered to passengers as well as the implementation details (including the concession periods) will also differ.

16. After sharing profit with passengers, profit margins of the NWFF and HKK for the first 18 operating months will be reduced to around 7.5% and 13.5% respectively. Profit margins of the NWFF and HKK in the previous licence period were 7% and 8.1% respectively. However, the profit margins of the remaining 18 months of the licence period are still subject to uncertainties in future. Therefore the eventual overall profit margins for the three-year licence period is not known at this stage, and it should not be projected simply by making reference to those achieved for the first 18 months.

(D) Arrangement for the remaining licence period

17. It is expected that the uncertain operating environment will prevail for the second half of the current licence period (i.e. the 18 months from 2016 to mid-2017), presenting considerable challenges to the operators. Oil price fluctuation is a key contributing factor, since fuel cost is one of the major operating costs of the two operators. Besides, oil price has been hovering at historic low level in the recent decade now and the pressure of price rebound may be building up. As a matter of policy, the SHM do not cover fuel cost (and staff cost). Therefore, it should be prudent not to reduce subsidies under the SHM for the remainder of the current licence period. In any event, upon the expiry of the current licence period in mid-2017, we will examine whether there would be any windfall profit for the second half of the current licence period, based on the actual operating data available at that time. If there exists any windfall profit, the same profit-sharing arrangement applicable to the first half of the licence period will then equally apply. On this, the Government and the operators have reached agreement.

Next Three-year Licence Period

18. The current licences for the six ferry routes will expire in

mid-2017[7]. In accordance with section 29(2) of the Ferry Services Ordinance[8], further extension of current licences of the six major outlying island ferry routes (started from mid-2011) for three years, would still meet the rule that the aggregated licence period after extensions shall not exceed 10 years. The two ferry operators, NWFF and HKK, have indicated their intent for extension of their licences in writing. The Government considers it desirable to extend the existing licences, with a view to maintaining the operation of the six ferry routes. There are two reasons. First, the services provided by the incumbent ferry operators are generally satisfactory (see paragraph 7 above). Second, past experience[9] tells that, due to the operating difficulties faced by the six ferry routes, and that outlying island ferry service is not easy to run, even if we receive bids during the public tender exercise, there would unlikely be new operators entering into market to provide ferry service. As such, bidders may request hefty fare increase.

19. With the experience gained so far in the current licence period (2014 – 17), we would work out a mechanism for application in the next licence period (2017 – 20) to deal with possible windfall profit. Our goal is to have the mechanism worked out early so that it could be in place when the new licences take effect. We have commissioned a financial consultant to provide financial analysis. The analysis will cover the projection of operating environment of ferry service in the next licence period. We will also decide whether and how SHM should continue in the next three-year licence period (2014-20) after taking into

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[7] The existing licence of "Central – Mui Wo" route will expire on 31 March 2017; the licences of the remaining five routes will expire on 30 June 2017.

[8] In accordance with section 29(2) of the Ferry Services Ordinance, "[t]he Commissioner [for Transport] may, at the request of the licensee, during any period while the licence is in force, extend the period of the licence for a further period or periods not exceeding 3 years at any one time, so that the period for which the licence was granted together with all extensions thereof shall not in any case exceed in the aggregate a period of 10 years".

[9] It was shown in the two tender exercises conducted in 2007-08 and 2011 that tenderers returned with fare increase rates that were relatively high. In fact, in the two tender exercises, only one bid was received for each of the two packages of the ferry routes. In the tender exercise conducted in 2007, the tenderers indeed proposed to increase the average fares for some of the routes by some 30% to 50%. This hefty fare increase proposal was unacceptable. Re-tendering was arranged for those routes and some relief measures were introduced for these routes (SHM were then not yet provided). The average fare increase rates were eventually reduced substantially to range from 5.5% to 23%. In the 2011 tender exercise, the increase rates of average fares proposed in the tender bids ranged from some 22% to 55%. As a result of negotiation efforts and provision of SHM, the average fare increase rate was reduced to about 10%.

account the consultant's analysis.   Fare matters will also be considered.

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

20. In 2013, the Government proposed taking forward the construction of additional floors at Central Piers Nos. 4 to 6, to provide shop rental income to subsidise the operation of the six routes. When the proposal was submitted to the Public Works Sub-committee under the FC for consideration, Members raised concerns over the rental income and operations and management issues[10], and voted down the proposal of upgrading the construction project to Category A. Having regard to Members' concerns, we are reconsidering whether the proposal of providing rental income for subsidising the operations of the six routes is still feasible and desirable. We will consider this issue in conjunction with the matters related to subsidy and licence period set out in paragraphs 21 and 22 below, in deciding the most suitable permanent subsidy model for maintaining ferry service and achieving fare stability for the long term.

21. It has already been the second licence period since the Government first provided SHM to the six major outlying island ferry routes in mid-2011. Over the period, SHM have served the purpose as intended, and the implementation of the scheme has been further enhanced, with the mechanism for sharing windfall profit. In the next licence period (2017 – 20), the Government will study whether SHM should continue to be applicable to those six ferry routes, **and decide in the context of the next mid-term review in 2019 whether SHM (instead of using rental income to be generated by Central Pier Nos. 4-6 as subsidy) should become a permanent subsidy to maintain ferry services and fare stability for the long term.**

22. We will also examine any necessary complementary policies. Among them, licence duration is critical. The law now only allows for licence period to last for three years at one time and the aggregate period of the licence with all extensions shall not exceed 10 years. **We will look into whether the current duration of each licence period of only three years is too short, and whether that would hinder ferry**

[10] 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.

operators' capability to make longer term planning.

23. There are a total of 14 licenced outlying islands ferry routes in Hong Kong. Apart from the six major outlying island ferry routes, there are eight outlying island ferry routes[11]. **We note the requests from some of the residents in outlying islands that the Government should consider expanding SHM to those eight routes. The Government will conduct a study.** The study will cover a whole host of factors, including the principle of prudent use of public money, and the operating environment and financial situation of each of the eight routes etc. We will also consider factors such as the current arrangements of alternative public transport, and the residents' acceptability of fares. The study is expected to be completed within 2017, and the outcome will be reported to the Islands District Council.

WAY FORWARD

24. We will commence negotiation with the incumbent operators of the six major outlying island ferry routes on the extension of the next three-year licence period. Members' views are hereby sought. Our plan is to report the detailed arrangement of the next licence period to the Legislative Council Panel on Transport and Islands District Council in Q4 2016, and to seek funding approval for SHM (if needed) from the FC.

Transport Department
April 2016

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[11] 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".