

Chairman's Statement

The KMB logo is displayed in a large, bold, white font against a dark, textured background. The letters are stylized, with the 'K' and 'M' being particularly prominent.

We are committed to devoting our resources towards improving our service and ensuring
total customer **satisfaction**

Those of us in the public transportation business are sometimes asked when next we plan to raise fares. Our response to this is very clear: we prefer to devote our resources towards improving our service and ensuring total customer satisfaction so as to attract more passengers and avoid the need for fare increases as far as possible. Indeed, our entire strategy is designed around this concept.

We recognise that during the economic downturn, many people turned to bus transportation primarily because of cost considerations. During this period, and the subsequent recovery process in 2000, we did, and continue to do, everything possible to improve the convenience and comfort of our service to retain our passengers and attract new riders.

This strategy has proved its merit and benefited both our customers and our shareholders. Our profits have grown because of the increased ridership combined with sound management practices, cost control measures, and continuous improvements in productivity.

Determination of Bus Fares

This strategy also takes account of the fact that the fares charged by the operators of franchised public bus services are subject to the maximum fare levels in the fare scales prescribed by the Chief Executive in Council under the Public Bus Services Ordinance (Cap. 230). In December 2000, the Government announced certain modifications to its approach in considering future bus fare adjustments.

Among other things, the new approach, which took effect from 12 December 2000, would require that, in any year during the period between the last fare adjustment and the next fare adjustment, any return achieved by a bus operator on top of the historical average rate of return on Average Net Fixed Assets ("ANFA") of the franchised bus industry in the past 10 years in 1990-1999, viz. 13%, should be shared equally on a 50/50 basis between the operator and passengers. In view of the complexity of the approach, we have reproduced in full on pages 13 to 16 of this report the Legislative Council Brief issued by the Transport Bureau of the Government of the Hong Kong Special Administrative Region ("HKSAR") for general information.

Results for the Year

The Group's profit attributable to the shareholders for the year ended 31 December 2000 was HK\$854.7 million, representing an increase of 15.7% over the HK\$738.6 million for the previous year. The profit from the franchised bus operations, The Kowloon Motor Bus Company (1933) Limited ("KMB") and Long Win Bus Company Limited ("LWB"), amounted to HK\$827.0 million, an increase of 17.4% over the HK\$704.3 million for 1999. Earnings per share for the year were HK\$2.12 compared with HK\$1.83 for 1999.

Dividends

At the forthcoming Annual General Meeting, the Directors will recommend the payment of a final dividend of HK\$1.25 per share for the year ended 31 December 2000. This compares with HK\$1.07 per share for 1999. Together with the interim dividend of 33 cents per share paid on 10 October 2000 (1999: 28 cents per share), dividends for the year will amount to HK\$1.58 per share compared with HK\$1.35 for the previous year. The total dividend payout for the year will amount to HK\$637.8 million compared with HK\$544.9 million for 1999.

Outlook

We remain confident in the future of the Group and the public bus transportation industry, as there will be ample room for business and profit growth. Looking ahead over the next decade, there will be both challenges and opportunities. A very significant recent development is the Government's highly aggressive rail development strategy that involves a series of rail projects, including the West Rail linking the west and northwest New Territories with the urban areas, the Mass Transit Railway ("MTR") Tseung Kwan O Extension, the Ma On Shan Rail and the eventual extension of the East Rail of the Kowloon-Canton Railway ("KCR") to Tsim Sha Tsui.

In the short term, these developments will mean intensified competition for KMB and the bus transportation industry in general. However, history has shown that whilst new rail developments do divert some passengers from buses to rail, the development of new towns made possible by the new rail infrastructure will, over time, create new demand for bus transportation.

Whilst railways generally provide a fast, congestion free,

environment friendly form of transport, they have certain limitations when compared to bus service: railways run on fixed tracks, passenger catchment areas are relatively small, and distances between stations are relatively long. People who live beyond walking distance of railway stations need feeder buses and other forms of transport to connect with the train.

We actively participate in Government studies, including SCOPTS (Studies on Co-ordination of Other Public Transport Services with New Railways) commissioned by the Transport Department, to co-ordinate Hong Kong's public transport services with new rail services. The Transport Department, other government bodies, the two railway corporations and the franchised bus companies are active participants in various working committees of these planning projects.

We contributed substantially to these studies to ensure the smooth transition of bus operations before and after the new rails come into service. Studies on four planned railways, namely, the West Rail, the MTR

Tseung Kwan O Extension, the Ma On Shan Rail, and the East Rail Extension to Tsim Sha Tsui, are being finalised. The likely impact of these new rail projects on our operations has been factored into our forward planning. We will continue to play a part in SCOPTS in regard to other scheduled rail projects to ensure our interests coincide with those of the public.

While public transportation is a highly competitive business, we place strong emphasis on developing co-operative arrangements with other transport operators that bring mutual benefits and result in a more integrated public transportation network. Our work with SCOPTS and our bus-bus interchange schemes are examples of this. The latter enables our passengers to transfer not only between KMB buses, but also between them and buses of other companies as well as the railways. As the schemes require fewer buses, environmental concerns are also addressed by easing congestion and reducing pollution along urban thoroughfares.

Over the past three years, we have been successful in avoiding fare increases because of increased ridership and stringent cost control measures. It must however be pointed out that there are costs over which we cannot control. During 2000, for example, the average price per litre of diesel almost doubled from the price we paid in 1999. Also, the continual upgrade of our bus fleet and the installation of environmental protection measures represent considerable investments of capital.

Long Term Strategy

The Group continues to explore business diversification within the bus transportation sector in the HKSAR and Mainland China. A new joint venture in Tianjin, Mainland China was established at the end of 2000. We are building our non-franchised business through both organic growth and acquisitions in Hong Kong. Our new 'Multi-media On-board' ("MMOB") services provide opportunities for advertising revenue and other e-businesses. When the West Kowloon Depot is completed toward the end of 2001, the existing Lai Chi Kok Depot will be redeveloped into residential property.

The Group aims to achieve excellence in service and value for money for our customers and the highest possible return to the shareholders. The Group has maintained a very good record in profit growth and dividend payouts to shareholders over the past years. In this regard, we are pleased that the Group has been selected as one of the 220 component companies of the Dow Jones Sustainability Group Index ("DJSGI") since September 1999. The DJSGI tracks the performance of the leading companies in terms of sustainability in 68 sectors and 22 countries. The component companies represent the top 10% of companies with leading sustainability performance in the world.

Management is dedicated to ensuring effective and efficient operations, and doing all we can for the betterment of our community. We will keep this momentum moving forward as we build upon our past achievements.

Social Responsibility

Our franchise for public bus services is a privilege to serve the community. By offering the best quality service possible, we aim to continue to earn the right

to retain this privilege. We are especially proud of our efforts in the area of environmental protection. We recognise that bus operations can contribute to environmental, particularly air and noise, pollution, but we are doing our very best to improve our vehicles and the operations of our depots.

Our People

The performance and aspirations of the Group depend on the skills, dedication, discipline and teamwork of our people. Management is committed to helping our staff to develop through the best training and development programmes possible. The Board thanks all employees for their invaluable contributions to the business over the past years and we have no doubt of their dedicated and continued support in the coming years.

Directors

Under the Public Bus Services Ordinance, the Commissioner for Transport and the Deputy Secretary for Transport are appointed by the Chief Executive of the HKSAR Government to sit on the Boards of KMB and LWB. During 2000, the incumbents of

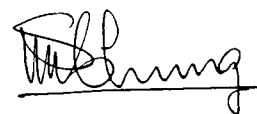
the Commissioner for Transport and the Deputy Secretary for Transport posts were Mr. Robert Footman, JP and Miss Linda Lai respectively. On 2 January 2001, Mr. Arthur Ho, Deputy Secretary for Transport, was appointed to the Boards of KMB and LWB in place of Miss Linda Lai. I would like to express my sincere appreciation for the valuable contributions that Mr. Footman, Miss Lai and Mr. Ho made as Board members.

Mr. Lui Pochiu and Mr. Edmond Ho Tat Man were appointed as Directors of the Company, KMB and LWB effective 1 January 2001. I would like to welcome them to the Board.

My thanks go also to the Audit Committee, chaired by Mr. George Chien Yuan Hwei with Dr. Kung Ziang Mien, James, OBE and the Honourable Eric Li Ka Cheung, JP as members, for the painstaking and professional work they have done during the year.

Lastly, I want to thank my fellow Directors, in particular the Managing Director, Mr. John Chan, GBS, JP, and our dedicated staff, for their

contributions towards the successful performance of the Group.



S. Y. Chung
Chairman

LEGISLATIVE COUNCIL BRIEF**REVIEW OF THE BASIS FOR CONSIDERING BUS FARE ADJUSTMENTS****INTRODUCTION**

At the meeting of the Executive Council on 12 December 2000, the Council ADVISED and the Chief Executive ORDERED that -

- (a) in assessing bus fare adjustment applications for the purpose of making recommendations to the Chief Executive in Council in determining the scale of bus fares, the Administration should continue to take into account a basket of factors including:
 - (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;
 - (v) the quality and quantity of service provided; and
- (b) the above approach should be modified as follows:
 - (i) in measuring an operator's return, both the net profits to shareholders and the borrowing costs incurred should be included;
 - (ii) the average net fixed assets (ANFA)¹ should be used as the basis for measuring an operator's rate of return;
 - (iii) in any year during the period between the last fare adjustment and the next fare adjustment, and subject to (d) below, any return achieved by a bus operator on top of the historical average rate of return on ANFA of the franchised bus industry in the past 10 years in 1990-1999 viz. 13% should be shared equally on a 50/50 basis between the operator and passengers;
 - (iv) in considering reasonable rate of return to operators, reference should be made to the historical rates of return on ANFA of the franchised bus operators; and
 - (v) in considering public acceptability and affordability of bus fare adjustments, reference should be made to changes in the Composite Consumer Price Index (CCPI) since the last fare adjustment;
- (c) the arrangements set out in (a)-(b) above, which may be referred to as the Modified Basket of Factors (MBOF) approach, should not operate as an automatic formula; there should be flexibility in applying the MBOF approach for considering bus fare adjustment applications;
- (d) the arrangement for the sharing of above-average return in (b)(iii) should take effect from the date of approval of the MBOF approach i.e. 12 December 2000; and
- (e) the MBOF approach should be reviewed every five years.

BACKGROUND

2. Under section 13(1) of the Public Bus Services Ordinance (Cap. 230), the Chief Executive in Council has unfettered powers in determining the scale of bus fares. In assessing bus fare adjustment applications for the purpose of making recommendations to the Chief Executive in Council, the Administration takes into account a basket of factors (BOF) referred to in paragraph 1(a) above.

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.

¹ANFA is the average value of assets at historical cost net of depreciation, except for land where no depreciation is charged.

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

4. On 27 October 2000, we briefed the Legislative Council (LegCo) Panel on Transport on the results of the review and sought Panel members' views on our proposals viz. the MBOF approach to improve the existing basis for considering bus fare adjustment applications. The MBOF approach builds on the existing basis and contains suitable modifications to improve its objectivity and transparency. Details of the MBOF approach are explained in paragraphs 5-14 below.

MODIFIED BASKET OF FACTORS (MBOF) APPROACH

ANFA to be used as the basis to measure an operator's rate of return

5. We would measure an operator's rate of return by benchmarking return which comprises profit and borrowing costs against its ANFA. This benchmark is used because ANFA is a well-accepted basis used by the Administration to measure the rates of return of public utilities. This approach is easy to understand. The purpose of using ANFA as the basis to measure rate of return is to encourage investors to continue to invest in fixed assets to upgrade service quality.

6. In monitoring the franchised bus operators, we have in place appropriate mechanisms for controlling their ANFA which consists mainly of buses and depots, and there are safeguards to prevent over-expansion of ANFA by the operators. For example, the operators are required under the Public Bus Services Ordinance to put forward a 5-year forward planning programme (FPP) on an annual basis to the Commissioner for Transport for agreement. Their plans to acquire buses and build depots are submitted in the context of the FPP and these plans are scrutinised very carefully having regard to operational requirements and other relevant considerations before agreement is given. Also, under the MBOF approach, we make reference not only to rate of return on ANFA but also to other relevant factors including public acceptability and affordability in assessing bus fare adjustment applications.

Inclusion of both net profits and borrowing costs in measuring an operator's return

7. Under the MBOF approach, both the net profits to shareholders and the borrowing costs incurred would be included in calculating an operator's return. This is because given that an operator's rate of return is calculated on the basis of ANFA, which can be financed by shareholders' investment and/or by borrowing, and the capital structure of a company is a business decision, shareholders should bear the borrowing costs if a bus operator wants to finance its operation through borrowing. This arrangement would also encourage the bus operators to move towards an appropriate capital structure.

Sharing of above-average return

8. In order to stabilise future bus fares, in future, any return achieved by a bus operator on top of the historical average rate of return of the franchised bus industry would be shared between the operator and passengers. Under the MBOF approach, any above-average return in a year would be shared equally on a 50/50 basis between the operator and passengers, i.e. 50% of the above-average return for that year would be deemed as future revenue of the operator. This arrangement would help relieve the pressure for future fare increases. On the other hand, by allowing bus operators to take 50% of the above-average return, it would provide an incentive to the operators to improve their performance and enhance efficiency.

Trigger point for sharing of above-average return

9. The historical average rate of return on ANFA of the franchised bus industry in the past 10 years (1990-1999) would be used as the trigger point for the sharing of above-average return. Reference is made to the historical rates of return in 1990-1999 because this period is long enough to cover times of relatively stable operation in the bus industry as well as times of relatively more changes with the introduction of new bus operators and changes in the economic situation in Hong Kong.

10. The historical average rate of return in the past 10 years is 13%, worked out by calculating the average of the actual rates of return on ANFA achieved in respect of all bus franchises which existed during 1990-1999. Under the MBOF approach, any above-average return achieved by a bus operator in any of its accounting year since its previous fare adjustment, including the above-average return which is forecasted to achieve before the date of its next fare adjustment would be shared equally between the operator and passengers. The part shared by passengers would be deemed as future revenue and taken into account in assessing the fare adjustment application. This sharing arrangement will take effect from 12 December 2000 i.e. the date the decision was made to adopt the MBOF approach.

No guaranteed return or maximum ceiling on return

11. In considering reasonable rate of return to operators, reference would be made to the historical rates of return on ANFA of the franchised bus operators. However, the operators would not be guaranteed any specific rate of return. The 13% rate is only a trigger point for the sharing of above-average return. It is not a target rate of return nor a ceiling on the rate of return that could be achieved by bus operators.

Reference to changes in CCPI

12. Reference would also be made to changes in the CCPI when we consider the public acceptability and affordability of bus fare adjustments. The CCPI, which aggregates expenditure patterns of 90% of the households, would provide a more comprehensive basis on how we consider this factor in assessing fare adjustment applications.

Consideration of Service Performance

13. As in the past, we would take into account the quality and quantity of service provided by the operators in making recommendations on bus fare adjustments. Whilst there is no formula linking service quality/quantity with the recommended rate of fare increase, we made reference to a number of objective indicators relating to different aspects of service performance of the bus operators. These factors include performance against approved schedules of service, fleet availability, average bus age, accident rate, breakdown rate, complaints received, etc. In addition, we also made reference to the results of the passenger opinion surveys on the major bus operators. These surveys are conducted on a regular basis by an independent and reputable survey company and co-ordinated by Transport Department. All the above are taken into account when we formulate our recommendations on fare adjustment applications.

Flexibility

14. The arrangements set out in paragraphs 5-13 above would be applied with suitable flexibility so as to take into account the different degree of maturity and operating environment of different bus operators as well as changes in the business environment. The MBOF approach would not operate as an automatic formula. For example, flexibility would be allowed in considering whether the rate of fare increase should be allowed to exceed or be kept below the change in CCPI. Each fare adjustment application would be considered on its own merits taking into account all relevant factors in the MBOF approach.

Future Review

15. The MBOF approach would be subject to review every five years to take into account changes in the operating and economic environment. This arrangement 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 and earn additional profits. It is noted that the fare setting process of major industries in many overseas countries are also reviewed every five years.

FINANCIAL AND STAFFING IMPLICATIONS

16. There are no financial or staffing implications for the Government.

ECONOMIC IMPLICATIONS

17. Under the MBOF approach, reference would be made to changes in the CCPI in considering public acceptability and affordability of bus fare adjustments. This would be one of the relevant factors to be taken into account in assessing bus fare adjustment applications. On the other hand, the new arrangement for sharing of above-average return between the operators and passengers could help stabilise future bus fares and hence reduce the impact of bus fare increases on inflation.

PUBLIC CONSULTATION

18. We consulted the franchised bus operators in June 2000 and the TAC in September 2000. We also gave a briefing to the LegCo Panel on Transport on 27 October 2000.

ENQUIRIES

19. Enquiries concerning this brief should be directed to the following officer-

Ms Zina Wong
Assistant Commissioner for Transport
Tel. No. 2829 5210

Transport Bureau
14 December 2000

(Note: This document was obtained from the Legislative Council Secretariat)