For information
December 2003

LEGISLATIVE COUNCIL PANEL
ON FINANCIAL AFFAIRS

RESULTS OF FURTHER STUDIES ON PROPOSAL TO TURN RATING AND VALUATION DEPARTMENT INTO A TRADING FUND

Purpose

We informed Members previously about the Administration's intention to further explore a proposal to move Rating and Valuation Department (RVD) from a traditional vote-funded department to trading fund status. This information note reports to Members the results of the further studies, and the Administration's conclusion that there is no strong case for setting the Rating and Valuation Trading Fund (RVTF) at the current juncture.

Background

2. At the Panel meeting on 3 June 2002, we briefed Members on the findings of a preliminary study conducted in 2002, which stated that there should be a business case to establish the RVTF as a means to enhance the financial flexibility and autonomy for RVD to operate on a more commercial basis. It was envisaged, at the time of the study, that full cost accountability would drive RVTF to secure greater efficiency and higher productivity, and that RVTF could exploit its property information database to support a more informed and transparent property market. We also reported that RVD staff in general agreed with the objectives of securing efficiency and productivity improvements, although concern over job security and promotion prospects had been expressed. In concluding, the Commissioner of Rating and Valuation (CRV) proposed to proceed

with the preparation of the detailed business plans and financial projections for the proposed RVTF in order to further explore its financial viability. Members asked us to report the results of the financial studies to the Panel when ready before taking forward the proposal.

3. In the process of preparing for the financial projections, business plans and service level agreements (SLAs) with his major client bureaux/departments as undertaken, CRV identified certain changes in circumstances that would adversely affect the business case and financial viability of the proposed trading fund. These recent developments, our latest assessment of the situation as well as proposed way forward are set out in the ensuing paragraphs.

Original Business Case

4. As a trading fund, the proposed RVTF would be expected to be self-financing from receipts on a full cost basis and to achieve financial performance targets set by the Financial Secretary, including making a return on its assets (or ANFA, average net fixed assets). As shown in the list of the services provided by RVD at ***Annex A***, RVD's major clients are in the public sector. The cost of providing services to the Financial Services and the Treasury Bureau (FSTB) and the Housing, Planning and Lands Bureau (HPLB) accounts for 80% and 9% respectively of the proposed RVTF's full cost. Under the original business case, the self-financing targets would have been met by setting the income from RVTF's public sector clients under agreed SLAs at the appropriate level. The enhanced management flexibility and accountability would then be leveraged to provide additional financial benefits in terms of dividends and productivity commitments to service users/the centre. The financial projections under the original business case (which assumes that service charges are set to cover the full cost plus required return on ANFA requirements) show that the proposed RVTF would be able to meet the proposed 10% return on ANFA, ranging from 9% to 12% in the initial years of operation from 2004-05 to 2007-08.

Significant Changes in Circumstances and Latest Developments

5. However, since the trading fund proposal was originally proposed, a number of significant changes have occurred.

6. Under the original business case, it was envisaged that the proposed RVTF could recover 9% of its cost plus a return from HPLB in the form of service payments. However, HPLB has advised in late 2002 that they were contemplating a policy change, i.e. the statutory services provided under the Landlord and Tenant (Consolidation) Ordinance as well as some non-statutory services would likely cease. The services account for about 6.3% of RVD's full cost. These changes would mean reduction in the service fees payable by HPLB to the proposed trading fund. This has made the financial situation of the proposed trading fund less viable.

7. Secondly, the Government is striving to make savings across-the-board to meet the announced target of containing the overall operating expenditure level at $200 billion by 2008-09. In CRV's discussions with client departments on the drawing up of service level agreements etc., some departments have indicated plans to reduce service demand. In addition, all the department's public service clients are likely to reduce their service payments to the proposed RVTF in order to meet their efficiency targets. As more than 99% of the proposed trading fund's full cost and hence revenue receipts come from its public sector clients and less than 1% come from potential private sector business under the original business case, it would be difficult, in the current environment, for the proposed trading fund to make up for the reduced income from public sector clients through developing new business.

8. Thirdly, the potential demand for new property information services is likely to be lower. Under the original business case, one of the drivers for RVD to move to trading fund was that surplus staffing resources released from efficiency improvements could be redeployed to provide new services which add value to customers of RVD. Development of new service provisions is thus a positive way to move RVD forward to increased efficiency and service quality. However, over the past few years, the property market has been subdued. This has weakened the prospect of

generating additional revenue by developing and providing new services to the public and the property industry.

Change in Financial Viability

9. Because of the significant reduction in service payments from public sector clients and dim prospect of expanding receipts from private sector clients through the provision of new property information services, the revenue stream of the proposed trading fund would be lower than that forecast in the original business case and also highly uncertain. As a result, it is unlikely that RVTF would be able to break even or provide a return on assets at least in the near to medium term. As set out in the projection at ***Scenario 1 of Annex B***, under the original business case, RVTF would be able to generate an average of 10% return on its ANFA in the initial years of operation. We would expect RVTF to contribute to the Government's overall savings target averaging at 11% for the five-year period to 2008-09. However, as shown in ***Scenario 2 of Annex B***, after RVTF has reduced its operating expenditure accordingly, it would sustain negative return on ANFA at least in the three years of operation starting 2005-06, ranging from -1% to -3%.

Assessment

10. Our overall assessment is that because of the above-described changes in circumstances, many of the benefits envisaged when the original business case was prepared may be delayed, or at least harder to realise in the short to medium term under the current environment. As a result, it is unlikely that RVTF would be able to break even or provide a return on assets at least in the near to medium term future. There does not seem to be a strong case, under the current circumstances and taking into the latest developments, for turning RVD into a trading fund.

Other Options

11. We have considered whether it would be feasible and beneficial to move RVD to a trading fund with extended transitional support. This support might need to include: protecting RVTF's revenue from its customer departments; not requiring RVTF to deliver a return on ANFA or dividends in the initial years of operation; and setting the service payment to be made by its major client at a level to enable RVTF to achieve break-even within the short to medium term after its establishment. These options are considered undesirable. As pointed out in the research conducted by the LegCo Secretariat in 2002-03 on the effectiveness of trading funds, the issue of whether services of the trading funds should be more exposed to market competition is worth considering in the deliberation of future trading funds. Protecting RVTF's revenue or waiving the requirement on the Trading Fund to deliver a return on ANFA or dividends is not in line with the spirit of more exposure to competition.

Staff Reaction

12. As part of the re-evaluation work, focus groups and survey were conducted to assess staff's views on the proposed move to a trading fund. While endorsing the objectives of efficiency improvements and savings, many RVD staff expressed doubt over the financial viability of the proposed trading fund under the current economic and financial environment. Some staff was of a view that proceeding with the trading fund at this juncture would increase staff anxiety about job security and career prospects.

Way Forward

13. We will put on hold the plan to turn RVD into a trading fund until there is a sounder business case and the environment is more conducive to delivering the full benefits of a trading fund.

14. As a vote-funded department, RVD will continue to look for opportunities to achieve productivity gains. Specifically, like other

bureaux and departments, it will have to contribute to the Government's overall target in delivering additional savings over a period of five years starting from 2004-05. To this end, RVD is planning to pursue a number of efficiency initiatives through re-engineering, re-structuring, and more outsourcing in the future.

15. Members are asked to note the contents of this paper.

Financial Services and the Treasury Bureau (Treasury Branch) /
Rating and Valuation Department
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Annex A

Rating and Valuation Department
List of Services and Share Percentage of RVD’s Full Costs

Services/Activities	**% of Full Costs (of proposed RVTF)**	**Customer**
Statutory valuation and billing services including recovery of arrears in relation to rates and Government rent	80%	FSTB
Statutory and advisory landlord and tenant services, e.g. • Monitoring repossession cases and processing applications under Landlord and Tenant (Consolidation) Ordinance • Advisory services to landlord and tenants Property research services	6.3% 2.7%	HPLB
Valuation and rental advice to other government departments or public bodies including building numbering services	10%	User department/ public bodies
Valuation and property related services to the public, e.g. • rates/Government rent account confirmation • property Info-Hotline • publications • processing landlords/tenants related applications	1%	Public

Annex B

Financial viability of RVD as a trading fund

- Original business case and Scenario reflecting changes in circumstances and recent developments

Scenario 1: Financial position of <u>original</u> business case

The original 4-year financial projections were

Scenario 1	**2004-05**	**2005-06**	**2006-07**	**2007-08**
Revenue	$673.8M	$679.2M	$684.6M	$684.6M
Operating Expenditure	$629.8M	$620.3M	$626.8M	$631.9M
Profit before tax and interest	$44.0M	$58.9M	$57.8M	$52.7M
Profit before interest after taxation	$38.0M	$50.4M	$49.4M	$45.0M
Return to ANFA achieved (%)	9%	12%	12%	11%

Under the original financial projections, RVTF would, in general, be able to meet the proposed 10% return on ANFA requirement in the initial years of its operation.

The features and assumptions of this scenario are:

- Assume revenue comes from service charges on Service Level Agreements with major client bureaux and departments and service payments from other government departments and the public.
- Expected rate of return on ANFA is assumed to be 10%.

Scenario 2: With potential erosion of service payments as a result of changes in circumstances and reduction in operating expenditure in line with government-wide requirements

The revised financial positions are:

Scenario 2	**2004-05**	**2005-06**	**2006-07**	**2007-08**
Revenue	$617.3M	$576.2M	$567.5M	$553.9M
Operating Expenditure	$604.6M	$581.8M	$574.1M	$564.9M
Profit before tax and interest	$12.7M	-$5.7M	-$6.6M	-$11.1M
Profit before interest after taxation	$11.8M	-$5.7M	-$6.6M	-$11.1M
Return to ANFA achieved (%)	3%	-1%	-2%	-3%

Under this scenario, RVD would have difficulty in breaking-even and delivering any return on ANFA in the medium 4-year timeframe (annual rate of return ranging from -3% to 3%) even after RVTF has reduced its operating expenditure in line with the government-wide efficiency saving requirements. It demonstrates clearly that it is not practical for RVD to meet trading fund requirements for achieving a rate of return on ANFA.

This Scenario has reflected the following features/assumptions-

- HPLB's policy changes on landlord and tenant matters: decrease in service payments from HPLB as a result of agreed rationalization plan in 2003, removal of security of tenure in 2004-05, and discontinuation of advisory and mediation services in 2005-06.
- Across-the-board efficiency savings: decrease in service payments by all client departments and bureaux by 1.8% in 2003-04 and further decreases which would build up to 11% over five years from 2004-05.
- RVTF's operating expenditure is reduced by 1.8% in 2003-04. Starting from 2004-05, further expenditure cuts will build up to 11% over five years.