Bills Committee on Mass Transit Railway Bill
Thursday, 16 December 1999
Speech of Mr Fan Jiang, Executive Director, Goldman Sachs (Asia)

Chairlady, members of the Bills Committee, ladies and gentlemen, Good morning.

My name is Fan Jiang and I am the head of Fixed Income Research at Goldman Sachs Asia. My company is the financial advisor to the MTRC in relation to the proposed privatisation. I have been a fixed income research analyst first at Goldman Sachs in New York, and then, starting in 1994, at Goldman Sachs in Hong Kong. I currently rank as the No. 2 fixed income research analyst in Asia in the annual survey conducted by Institutional Investor magazine, whose research rankings are generally regarded to be the industry's standard.

In my capacity, I cover conglomerates and large-capitalization corporate issuers in the Greater China region. I am also in charge of bond market strategy as Goldman Sachs' corporate bond strategist. I have been analyzing the MTRC since 1995.

Although I have specific responsibilities at Goldman Sachs, I am ultimately accountable to my clients — that is, to a large group of sophisticated, institutional investors worldwide. My job is to provide these investors, both in Hong Kong and around the world, with credit information about issues, as well as market information, that is accurate and timely. I must also give them prudent, well-thought-out recommendations and market strategies. In order to gain and keep the trust of my clients, I must maintain a high level of objectivity, credibility, and integrity. This is the very foundation of my professional career.

My objective today is to share with my views on the importance of MTRC's existing fare mechanism i.e. the autonomy of the Corporation to set fares and regulated by competitive market forces - and to provide you with my perspectives as a fixed income research analyst and how I believe international bond investors would view the issue of fare determination when evaluating the credit of the MTR Corporation.

From an analyst's perspective, maintain the existing fare setting mechanism has far-reaching consequences for hundreds of investors worldwide in terms of their opinion both of the MTRC and of Hong Kong. Let me explain why this is the case.

MTRC is one of only a handful of successful railway companies in the world. To the best of my knowledge, it is one of the only few railway transport companies in the world that is able to operate independently and commercially without receiving subsidies from the Government. This is a direct result of being able to operate on commercial principles, which helps to build the MTRC's financial and operating strengths and lends MTRC the credit protection in the event of severe economic stress.

MTRC's compelling story has indeed attracted many high-quality investors, both foreign and domestic, and over the years, we have seen the buildup of a very stable and loyal investor base. These institutional investors have supported MTRC through its ups and downs, and I think they will continue to do so.

Why has MTRC attracted so many loyal investors?

- First and foremost, MTRC operates under commercial principles. One of the most important of those principles is the existing fare-setting mechanism. As you know, a company's recurring cash flow is mostly drawn from its core operating revenue. In MTRC's case, it is revenue from train tickets sold. Over the years, MTRC has been able to increase its cash flow by capturing a bigger share of the market, increasing passenger volume, lowering cost, improving efficiency, and providing new service coverage areas. But these are only necessary conditions to secure MTRC's financial independence. In order to overcome adverse market conditions including inflation, MTRC must have the flexibility to adjust its tariff rates from time to time, which is a sufficient condition for MTRC to preserve its financial independence. LegCo's decision in 1997 to maintain MTRC's fare-setting mechanism has been critical to the investors' support for the MTRC. It must be noted, however, that MTRC has exercised its right to set fares *conscientiously* and *responsibly*, taking into account the likely response from the public as well as competitive pressures from other modes of transport.

- The second reason that MTRC has attracted so many loyal investors is the high quality of its management. As an analyst who has been following the Hong Kong corporate sector for the last six years, I can report to you with confidence that MTRC's management is as conservative, commercial, effective and efficient as its counterparts in the private sector — if not more so. Operationally, management has also performed well. All of MTRC's development projects have been completed on time and within budget. Well-managed engineering and equipment tenders for the ongoing Tseung Kwan O line alone have saved MTRC over HK$6 billion. Cost-cutting, however, has not compromised the quality of its projects. To the contrary, MTRC is well known for its engineering execution and high quality services. Not surprisingly, investors have recognized this. At the height of the financial crisis, MTRC's bonds continued to be well-supported by many investors, and continued to trade at much tighter levels than other corporate bonds with equal credit ratings. When the Asian financial crisis gradually dissipated, MTRC's bonds were among the first to rally.

Can MTRC continue with this level of success in the next decade? I am confident it can *if* MTRC can maintain its existing operating and regulatory structure — including its ability to adjust fares when necessary.

What would happen to MTRC if its fare-setting mechanism were eliminated or restricted? Why do I believe such a move is inappropriate and destructive from a credit perspective? In the next several minutes, I would like to share with you some of my thoughts on these questions.

- If MTRC's fare-setting mechanism were altered, the certainty of the company's future income could be weakened significantly. Consequently, MTRC would be forced to cut back on its investment, including maintenance investment — ultimately leading to a long-term deterioration in the quality and safety of the services MTRC provides. In turn, passengers, including you and me, would be more inclined to seek alternative modes of transport, causing MTRC's passenger flow and revenue to suffer. If MTRC were unable to access capital markets for financing and refinancing, *where it wants and when it wants*, because of its weaker credit profile, it will be forced to seek subsidies from its majority shareholder, the SAR Government. The more MTRC had to rely on the Government financially, the more MTRC would be operating like state-owned enterprises, which unfortunately are often inefficient, wasteful, and unsafe, this, in turn, would hurt MTRC's revenue further. This is commonly described as a "spiral of decline." We only have to look at the majority of railway transport companies elsewhere in the world to see that this is true.

- A change in the fare-setting mechanism would also create disincentives for MTRC to make long-term investments and commitments. This runs contrary to the very nature of railway operation, which by definition requires long-term investment with very high up-front initial capital commitment. If MTRC had to depend on the Government to finance these capital needs, it would be the taxpayers who would indirectly, but ultimately, shoulder the burden.

- This brings us to the next point, which is extremely important: If we transfer the pricing mechanism, either in part or whole, from being market determined to a LegCo approved mechanism, we will be moving away from the free market principles that are the very cornerstone of Hong Kong's success. Institutional investors, irrespective of whether they hold MTRC bonds, will look at the decision to transfer pricing power from the well-managed MTRC to an external regulatory process as additional evidence of a move towards a more government regulated market. This would also diminish Hong Kong's hard-earned and deserving credit image in the international investment community. As an analyst who has been relentlessly promoting Hong Kong and who has seen how specific events can affect investors' sentiment, I believe such a move would be most unfortunate. Given our unique surrounding, the consideration of pricing power transfer has an ironic ring — while China is gradually transferring decision-making power from the state to the market, Hong Kong would be seen as moving in the other direction.

- Equally damaging is the impact on existing bond investors and their perception toward credits in Hong Kong. Most of the institutions who have invested in MTRC understand that the company's existing fare-setting mechanism is an integral part of the credit protection that is well documented in its bond offering prospectus. These institutions, which hold approximately HK$20 billion of MTRC bonds, would invariably review, and most probably revise, their investment strategies if there is a change in the fundamental premise of their investment. To international investors, a change in rules half-way through the game suggests a serious departure from the Government and MTRC's representations that are explicitly illustrated in the prospectus of MTRC's previous bond offerings. Given the fact that investors have correctly and justifiably viewed MTRC as Hong Kong's quasi-sovereign credit — and MTRC's bonds as Hong Kong's benchmark in the absence of Government bonds — any negative perception toward MTRC and its outstanding bonds would have a material and lasting impact on other credits in Hong Kong.

- Unlike equity investors, bond investors are primarily concerned with protecting themselves from downside risk. Naturally, investors need to carefully consider an issuer's earning predictability and operating consistency before they commit capital. If MTRC were to be deprived of the current fare-setting mechanism, its recurrent cash flow would be far less predictable and consistent. Without the characteristics of predictability and consistency, bond investors would invariably be exposed to substantial and asymmetric risk on the downside; but unlike equity investors, they would have little opportunity for compensation on the upside. Consequently, MTRC's credit story would lessen its appeal with investors, and its risk premium would rise. In my opinion, MTRC would be forced to pay a higher risk premium, unfortunately — not only for the risk they would have to take, but also for the uncertainty they would not wish to bear.

- In my view, the removal or restriction of the existing fare-setting mechanism does not necessarily protect public interests and is inherently counterproductive and inconsistent. I believe it makes little social and economic sense to control price while aggressively liberalizing the mass transit market. Needless to say, there must be checks and balances concerning pricing fairness. Fortunately for us, there is one. In my view, the combination of the Board of MTRC, which includes many outside directors and Government appointees, and MTRC's consultation process with the TAC and the LegCo Panel on Transport which will be formalized in the Operating Agreement, will ensure that existing fare-setting mechanism is not abused and that public interests are protected.

As is well known, the hallmark of Hong Kong is its efficient, open economy based on free market competition. Today, service operators, including those in the transport sector, must provide value for money, or they risk losing customers to their competition. This is certainly true for MTRC. To the credit of law and policy-makers and MTRC's management, the system has worked and MTRC has been a success. Our investors are impressed.

MTRC is one of the handful of successful railway credit stories in the world. It has worked successfully and there is no reason to tamper with it. In my view, it would be wise to leave the successful formula as it is.

Before I finish, please allow me to quote a great industrialist and a true pioneer of the 20th century, Henry Ford. Mr. Ford used to say, "don't argue with success." For those of us who have been following the market and the transportation industry, MTRC has been a phenomenal success. Its future is now in your hands, ladies and gentlemen of the Panel. Let us cherish, preserve, and protect the great success of MTRC.

Thank you for providing me with this opportunity to make our views known.

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