
VIEWS ON MASS TRANSIT RAILWAY BILL

BY

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Written Submission to the

BILLS COMMITTEE ON MASS TRANSIT RAILWAY BILL

Legislative Council

The People's Republic of China

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I. INTRODUCTION

We, Jardine Fleming Holdings Limited (“Jardine Fleming Holdings”), refer to your letter dated 16th November 1999 inviting comments from one of our subsidiaries, Jardine Fleming Investment Management Limited, on the Mass Transit Railway Bill (the “Bill”). We have reviewed various public documents in relation to the Bill and set out our views below.

The prime focus of our comments relates to investors’ perspectives towards the implementation of MTRC’s privatisation and how it will impact on the desirability of MTRC as an investment. We base our comments on information available relating to the broad terms and general principles of the structure of regulatory framework and the corporation, as well as the composition of the corporation’s business. Our views towards the marketability and attractiveness of MTRC to investors are expressed in general terms, without regard to the pricing and valuation of the shares, as such information has yet to become available. It is important to note that this document does not represent advice by any Jardine Fleming entity to the Government or the Bills Committee on the privatisation of the Mass Transit Railway Corporation (“MTRC”), but intends to set out our views as an international financial institution.

We welcome the proposed privatisation of MTRC and believe investors will be keen to consider investing in the company as one of their core equity holdings in Hong Kong. However, it will be important to ensure that the framework of privatisation, having been decided at Government policy and political level, is implemented in a way that allows MTRC shares to be sustainable both in the short and the long term as an attractive investment proposition. Sustainability relates to more than pure financial stability; it includes the capability to deliver the type and standard of operational services entrusted to it in an acceptable manner. Our experience internationally suggests strongly that to

remain attractive to investors the privatisation has to be seen as a success by all other major stakeholders, including consumers, employees, taxpayers and lenders.

The single greatest concern of potential investors is likely to be clarity in the structure of the investment proposition. The regulatory framework underlying the operations of MTRC will have a huge impact upon its cashflow, its growth potential and the nature of its business. Thus, it is important that the framework gives a clear picture of the operating environment so that these issues can be evaluated properly by investors in understanding the company's value.

We have considered the Bill in detail, and we support fully the proposal to privatise MTRC as a single entity. In our view, investors will be pleased that the property assets currently within the company are to be retained by MTRC after privatisation. In the following pages we have sought to present our views on the Bill, specifically with regard to the granting of the franchise, regulation of railway operations and bundling of property assets. In each case we have sought to analyse the Government's current proposal and how it will be viewed by the investment public. We have also raised a few other issues which may affect investor appetite.

II. GENERAL INVESTORS' CONCERNS

Our experience of overseas entities undergoing privatisation indicates that investors, when reviewing such investment opportunities, take into consideration three major factors: transparency of operations and finances, predictability of operational environment, and fairness and clarity of the regulatory regime. Having satisfied these three criteria, investors will be able to assess the company to determine whether it operates efficiently, allows promising business growth and offers reasonable returns.

A) *Transparency of Operations and Finances*

As a proposed listed company, MTRC will be subject to the regulatory requirements of the Securities and Futures Commission, with the listing application to be processed under the scrutiny of The Stock Exchange of Hong Kong Limited. The filing of documentation with the relevant authorities and the disclosure requirements at the time of listing (as well as periodically as a listed company) will address the issue of investor protection to safeguard investors' interests and concerns. Hong Kong's reputation as a leading financial market with able, effective regulatory bodies will bring confidence to investors, local and international.

B) *Stable Operational Environment*

Investors will look for a stable operational environment. Such stability allows for higher predictability of the company's business outlook and thus more precise valuation of the investment. Should the prospects be unknown or prone to be unduly volatile, investors will impose a discount. The regulations will not only define the parameters of the enterprise's own existence and future operations, but how the investor would view it as an investment opportunity in the new context.

C) *Fair Regulations*

One of the greatest areas of concern for investors in relation to the privatisation of MTRC relates to the form and extent of regulation. Investor concern will relate both to the extent to which regulation may constrain profitability or expansion, and to the potential volatility in share performance which could be expected should the regulatory framework lack certainty or stability. We believe that clarity of regulation is in everyone's best interests, including shareholders, MTRC and the public and the Government. Investors should be able to see clearly that MTRC will be run with sufficient autonomy as a

commercial organisation, while the regulatory framework is transparent and secure to provide protection against undue share price volatility.

1. Regulatory framework affects future cashflow and valuation

The regulatory framework will be of major significance as it will underpin – or undermine – future cashflow of MTRC. A clear regulatory framework reduces uncertainty over the future prospects of MTRC and allows the company to source debt more cheaply, as credit rating agencies will take account of the robustness of the operating environment in ascribing credit ratings. Agencies such as Standard & Poor’s have already made clear that changes in credit status could occur as the Government reassesses its support to an enterprise that also has private shareholders. They will monitor the privatisation very closely as the plan becomes more definite. This is likely to be a particular concern as utilities such as MTRC are typically heavily geared financially, and a stable operating environment thereby reduces the cost of capital to MTRC. If there is uncertainty over what the applicable rules are, or if it appears that these rules are liable to change for non-commercial reasons, both investors and lenders will react by seeking a higher return or being unwilling to pay as high a price. We believe therefore that it is important to have a sound regulatory framework in place from the outset.

2. Regulatory framework affects operational efficiency

The regulatory framework can be designed in a prescriptive or functional fashion. In more prescriptive permutations, investors tend to be concerned that the regulator’s level of involvement may be too high, so that the regulator becomes a de facto manager of the business being regulated. Such micro-management is not seen as acceptable, not least because the regulator may simply not have the management resources or professional expertise to “run” the business being regulated. Also, the setting up and operating costs

of the regulator which are typically charged to the regulated utility, can impact the profitability of the company.

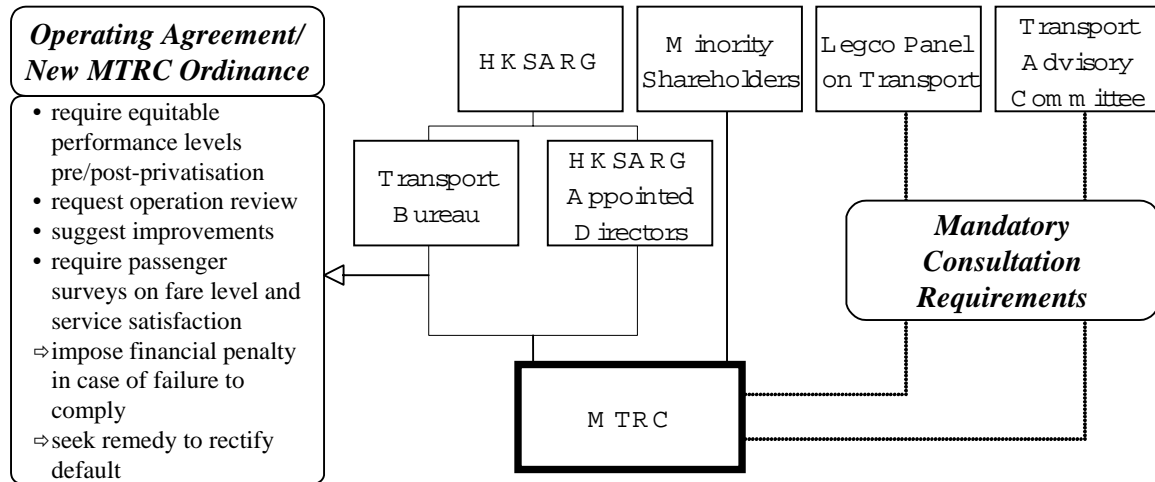
Investors will wish MTRC to retain control over the fare policy it adopts. Constraints upon operational freedom to increase prices will reduce management flexibility and efficiency, and therefore its ability to deliver performance. The existing consultation mechanism, where MTRC voluntarily approaches the Legco Panel on Transport and the Transport Advisory Committee at times of fare level adjustments, is well-established and has produced remarkable efficiency in addressing both public and investor concerns. Any additional limitation will impose rigidity on the pricing regulation and limit the scope under which MTRC can exercise optimal financial manoeuvrability.

3. Regulatory framework affects competitiveness

If the privatisation is to be a success in the longer term, it must be seen to deliver services to consumers at the most economic prices possible. There are international precedents to illustrate that not all regulated industries are required to set their tariff in a way approved by the regulator. Contrary to many railway operators overseas, MTRC will be subject to direct competition due to the distinct geographical limitations of Hong Kong, and such competition should ensure a fair competitive environment. Kowloon-Canton Railway Corporation poses direct competitive pressure on MTRC over development rights of new lines (the fourth cross-harbour tunnel, for instance), and the bus companies, public light buses, ferries and taxis are also alternatives throughout MTRC's network. Micro-management by regulators and third-party independent public bodies could serve to undermine MTRC's efficiency and the profitability it enjoys, and investors can be expected to be sensitive to this risk.

III. CURRENT PLANS FOR REGULATORY FRAMEWORK

MTRC after privatisation will be subject to various interest parties. The following diagram outlines our understanding of these relations with MTRC:



MTRC's Relations with Stakeholders

Minority shareholders	<ul style="list-style-type: none"> ▪ Through their shareholding in MTRC impact on share price performance
Legco Panel on Transport	<ul style="list-style-type: none"> ▪ Operating Agreement requires MTRC to conduct consultation before setting fare levels
Transport Advisory Committee	<ul style="list-style-type: none"> ▪ Operating Agreement requires MTRC to conduct consultation before setting fare levels
HKSARG/General Public	<ul style="list-style-type: none"> ▪ Through Transport Bureau monitor MTRC to ensure it carries out the duties and responsibilities required from the Operating Agreement and the new MTRC Ordinance ▪ Through the Government appointed directors safeguard the Government's interest as the majority shareholder

A) *Third Party Monitoring and Public Interest*

With this proposed regulatory framework, we believe that there exists an adequate control by the Government and other public bodies to protect public interest. It is mandatory for MTRC to consult the Transport Advisory Committee and Legco Panel on Transport

before fare level adjustments, a process which has already been practised by MTRC on a voluntary basis on its annual fare review. The Operating Agreement also sets out that passenger surveys have to be conducted to assess the level of public acceptance. The Government, through the Transport Bureau and under the advice of the Legislative Council and Transport Advisory Committee, will monitor MTRC to ensure its adherence to the specific provisions of the Agreement relating to safety standards, service commitments and performance requirements, as well as fare level determination.

B) Conflict of Interest of Majority Shareholder

There are concerns that the Government in being a major shareholder will be in a position to influence MTRC; such ownership rights may conflict with regulatory prerogatives. Indeed, minority shareholders would be very sensitive to any sign of use by the Government as the majority shareholder of its influence to constrain MTRC's potential for profit. The establishment of clear operational objectives through the Operating Agreement and third party overseers such as the Transport Advisory Committee and Legco Panel on Transport will mitigate such potential conflicts of interest.

C) Conclusions on Current Proposed Framework

We believe that MTRC can be privatised with the proposed regulatory framework composed of the consultation process and ongoing monitoring to ensure specific performance criteria are met, as set out in its contractual obligations to the Government under the Operating Agreement. Indeed, investors are likely to see this as a preferred situation with a clearly defined and objectively carried out process to ensure both consumers and investors' interests are being looked after. Lastly, keen competition from various other transport service providers in the territory will also ensure that MTRC will continue to operate on a competitive basis to maintain customer satisfaction and fair pricing. The competitive environment also highlights the importance for MTRC of

retaining its fare autonomy, in order to retain sufficient management flexibility to exercise its full potential and efficiency as a commercial organisation.

IV. OTHER ISSUES

A) Composition of MTRC's Business

We understand from the documents released by the Government that the entity to be privatised will include the totality of the property, rights and liabilities of the MTRC. We understand therefore that the cost of debt, for example, will not change at the point of privatisation and assume that the implicit guarantees given by the SAR Government, which have allowed access to debt at such existing rates, will be maintained without any additional charge to the privatised entity. In effect, the privatised MTRC will have a capital structure justifying the same credit rating as the state-owned utility enjoys at present. This will be a major attraction to incoming investors and current creditors.

In preparing this document we have reviewed the business profile of MTRC and have concluded that, despite an initial need to explain to investors their relevance to the core business of MTRC, it would be beneficial to include the property assets in the company to be privatised. The revenue from the property assets is an important contributor to the financial health of MTRC and the inflows associated with property development tend to coincide with the early phases of new projects taken on by MTRC where capital expenditure requirement is at its peak. Mass transit infrastructure tends to have to be in place in the early stages of any local development programme and some time before the customer load exists. The additional income associated with the sale or lease of property development rights is a major benefit in terms of reducing some of the early financial pressures of any such rail project. Furthermore, the integration of railway and property development can lead to synergies by way of development costs, infrastructural design and operational efficiency, with the potential to generate more cost savings and allow for better valuation by investors.

B) Valuation Issues

The single greatest factor affecting value will be the framework underlying the quality of earnings of MTRC. The level of gearing and the inclusion of property assets will also be of concern to investors. We understand that the corporate structure, debt levels and corporate assets of the company will not be changed because of the privatisation.

The dividend policy after privatisation will also be important to investors but no detailed policy has been enunciated on which we can comment.

C) Corporate Governance

The Bill specifies that Chief Executive may appoint not more than three persons to be additional directors of MTRC, yet there is little indication of any further changes to corporate governance. The issue will certainly be of significance to outside investors in determining the extent of ongoing control exercised by the Government in appointing senior management. We would expect the specific provisions to be included in the constitutional documents of the company.

In just the same way that the Government may wish to appoint directors to safeguard its interests, it will be important, particularly if a government agency is the only regulatory body for MTRC, that a majority of the board comprises non-government professional management.

Finally, the constitution of the salary and incentivisation committee of MTRC will be a subject of review and interest by financial investors.

D) Privatisation Process and Offering Mechanism

We note with interest the intention to structure the privatisation of MTRC as an IPO offers an attractive opportunity for the people of Hong Kong to participate as investors. We firmly support and agree with this approach. Quite apart from the fact that it is clearly appropriate for the users of the service to be able to participate in its ownership, institutional and international investors will also derive considerable confidence from such an approach, as it is likely to build support for MTRC as a privatised entity. We believe that it would be appropriate to have a widespread retail offer similar to that used for the Tracker Fund of Hong Kong. The retail offer will also give scope for creating customer loyalty and employee share ownership schemes that could help sustain the investment attractions for MTRC over the longer term.

V. CONCLUSIONS

We hope that the above comments are helpful in providing the Legislative Council with an additional perspective on the MTRC privatisation. There is a wide range of sometimes conflicting considerations to reconcile, and a successful flotation can be achieved using a range of different solutions. We have sought to indicate some areas where the valuation of MTRC may be affected depending upon the course of action adopted.