

Report of the Members of the Board

The members of the Board have pleasure in submitting their Report and the summary financial statements for the financial year ended 31 December 2003.

Principal Activities of the Group

The principal activities of the Company and its subsidiaries are:

- A** the operation of a mass transit railway system with lines from Central to Tsuen Wan (Tsuen Wan Line), from Yau Ma Tei to Tiu Keng Leng (Kwun Tong Line), from Po Lam to North Point (Tseung Kwan O Line), from Chai Wan to Sheung Wan (Island Line), from Hong Kong to Tung Chung (Tung Chung Line) and from Hong Kong to the Hong Kong International Airport at Chek Lap Kok (Airport Express Line);
- B** property development at locations relating to the railway system including the Tseung Kwan O Extension;
- C** related commercial activities, including the letting of advertising and retail space, bandwidth services on the railway system, property management and leasing management of investment properties (including shopping centres and offices), property agency and Octopus Card Building Access System services;
- D** the construction of the Penny's Bay Rail Link;
- E** the design, construction and operation of the Tung Chung Cable Car Project and related tourist development;
- F** the planning and construction of future extensions to the railway system and other related infrastructure projects;
- G** consultancy services covering all areas of expertise required in the project management, planning, construction, operation, maintenance and up-grading of railways plus fare collection, property integration/development advice including other property related services and advice on generation of non-fare revenues;
- H** the operation of a smart card system by Octopus Cards Limited, a subsidiary of the Company, for the collection of payments for both transport and non-transport applications; and
- I** equity investments and long term operation and maintenance contracts outside of Hong Kong.

Dividend

The Directors have recommended a final dividend of HK\$0.28 per Ordinary Share to be payable to shareholders whose names appear on the Register of Members of the Company on 2 April 2004. Subject to the passing of the necessary resolution at the forthcoming Annual General Meeting, such dividend will be payable on or about 30 June 2004, in cash in Hong Kong dollars, with a scrip dividend alternative.

Members of the Board

Members of the Board who served during the year were Raymond Ch'ien Kuo-fung (appointed non-executive Chairman with effect from 21 July 2003), Jack So Chak-kwong (whose term of office as Chairman and Chief Executive expired on 20 July 2003 and who ceased to be a member of the Board with effect from the same date), Chow Chung-kong (appointed Chief Executive Officer and a member of the Board with effect from 1 December 2003), Cheung Yau-kai, David Gordon Eldon, T. Brian Stevenson, Edward Ho Sing-tin, Lo Chung-hing, Frederick Ma Si-hang, the Secretary for the Environment, Transport and Works (Dr. Sarah Liao Sau-tung) and the Commissioner for Transport (Robert Charles Law Footman).

Christine Fang Meng-sang was appointed a Member of the Board with effect from 1 January 2004.

At the Annual General Meeting on 15 May 2003 and pursuant to the Company's Articles of Association ("Articles"), Cheung Yau-kai, Edward Ho Sing-tin, T. Brian Stevenson and Frederick Ma Si-hang retired under the Company's Articles of Association and were re-elected as members of the Board.

At the forthcoming Annual General Meeting and in accordance with the Articles, Raymond Ch'ien Kuo-fung and David Gordon Eldon will retire by rotation. Chow Chung-kong and Christine Fang Meng-sang, who were appointed by the Board after the 2003 Annual General Meeting, will retire under Article 85 of the Articles. All these four Board members will offer themselves for re-election at the forthcoming Annual General Meeting.

Brief biographical details for Board members are set out on page 16.

Following the departure of Jack So Chak-kwong mentioned above, Philip Gaffney, Operations Director was appointed Acting Chief Executive Officer with effect from 21 July 2003. He ceased to be Acting Chief Executive Officer upon the appointment of Chow Chung-kong as Chief Executive Officer with effect from 1 December 2003.

Alternate Directors

The Alternate Directors in office during the year were (i) Martin McKenzie Glass and Alan Lai-nin (both for Frederick Ma Si-hang), (ii) both the Permanent Secretary for the Environment, Transport & Works (Rita Lau Ng Wai-lan) and the Deputy Secretary for the Environment, Transport & Works (Paul Tang Kwok-wai [who ceased to be a Deputy Secretary for the Environment, Transport & Works after 31 October 2003], Arthur Ho Kin-wah, Margaret Fong Shun-man and Annie Choi Suk-han [who was appointed as a Deputy Secretary for the Environment, Transport & Works with effect from 24 November 2003]) (for the Secretary for the Environment, Transport & Works), and (iii) the Deputy Commissioner for Transport/Transport Services and Management (Judy Li Wu Wai-lok) (for the Commissioner for Transport).

Executive Directorate

The members of the Executive Directorate who served during the year were Jack So Chak-kwong (whose term of office as Chairman and Chief Executive expired on 20 July 2003 and who also ceased to be a member of the Executive Directorate with effect from the same date), Chow Chung-kong (appointed Chief Executive Officer and a member of the Board with effect from 1 December 2003), Russell John Black, William Chan Fu-keung, Philip Gaffney, Thomas Ho Hang-kwong, Lincoln Leong Kwok-ken and Leonard Bryan Turk.

Brief biographical details for members of the Executive Directorate during the year are set out on page 16.

Corporate Governance

The Company is committed to ensuring high standards of corporate governance in the interests of shareholders and devotes considerable effort to identifying and formalising best practices.

The overall management of the Company's business is vested in the Board of Directors. Pursuant to the Company's Articles of Association and the Protocol adopted by the Board of Directors, the Board of Directors has delegated the day-to-day management of the Company's business to the Executive Directorate, and focuses its attention on matters affecting the Company's overall strategic policies, finances and shareholders.

The Company takes care to ensure the Board is in a position to exercise its powers in an informed manner. The Board of Directors meets regularly and members of the Board receive information between meetings about developments in the Company's business. All members of the Board of Directors have full and timely access to relevant information and may take independent professional advice, if necessary. The Board of Directors held 12 meetings in 2003 and the average attendance rate was 85%.

The Board of Directors announced in April 2003 its decision to split the roles of the Chairman and Chief Executive Officer after Jack So Chak-kwong's contract as Chairman and Chief Executive expired during the year. Following that, Dr. Raymond Ch'ien Kuo-fung, a member of the Board, was appointed non-executive Chairman with effect from 21 July 2003, and Chow Chung-kong was appointed Chief Executive Officer and a member of the Board with effect from 1 December 2003.

As an integral part of good corporate governance, the following committees have been established. These committees comprise non-executive Directors who have been invited to serve as members.

Audit Committee

The Audit Committee meets four times each year to review the truth and fairness of the Group's financial statements and to consider the nature and scope of internal and external audit reviews. It also assesses the effectiveness of the systems of internal control. Internal control systems have been designed to allow the Board of Directors to monitor the Company's overall financial position and to protect its assets. The purpose is to guard against material financial misstatement or loss. The Board of Directors is responsible for these systems and appropriate authorisations and guidelines are in place. The Audit Committee Chairman also prepares an annual report to the Board of Directors covering its activities for the year and highlighting issues which the Chairman deems significant.

All the members of the Audit Committee are non-executive Directors, namely T. Brian Stevenson (chairman), Cheung Yau-kai and the Commissioner for Transport (Robert Charles Law Footman), two of whom are independent non-executive Directors. There were four meetings of the Audit Committee in year 2003 and the average attendance rate was 83%. The external auditors, the Finance Director and the Head of Internal Audit Department attended to answer questions on the reports or their work.

Remuneration Committee

The Remuneration Committee meets regularly to consider human resources issues, including the terms and conditions of employment, remuneration and retirement benefits of the Chairman, the Chief Executive Officer and members of the Executive Directorate. All the members of the Remuneration Committee are non-executive Directors, namely Edward Ho Sing-tin (chairman) who was a member of the Committee throughout the year, succeeded Dr. Raymond Ch'ien Kuo-fung as chairman of the Committee with effect from 4 September 2003, T. Brian Stevenson (with effect from 4 September 2003) and Frederick Ma Si-hang, two of whom are independent non-executive Directors. There was one meeting of the Remuneration Committee in year 2003 and the attendance rate was 100%.

Nominations Committee

The Nominations Committee carries out the process of recommending and nominating candidates to fill vacancies on the Board of Directors. A person may be appointed as a member of the Board of Directors at any time either by the shareholders in general meeting or by the Board of Directors upon the recommendation of the Nominations Committee. Directors who are appointed by the Board of Directors must retire at the first annual general meeting after their appointment. In either case, the Directors so elected and appointed are eligible for re-election and re-appointment. At each annual general meeting of the Company, one third of the Directors (or such number as is nearest to and less than one third) are required to retire from office by rotation (excluding the Directors appointed by the Chief Executive of the Hong Kong SAR under the Mass Transit Railway Ordinance).

All the members of the Nominations Committee are non-executive Directors, namely David Gordon Eldon (chairman), Lo Chung-hing and the Secretary for the Environment, Transport and Works (Dr. Sarah Liao Sau-tung), two of whom are independent non-executive Directors. There was one meeting of the Nominations Committee in year 2003 and the attendance rate was 100%.

The Board of Directors was of the view that both the Nominations Committee and the Remuneration Committee should be involved in the process of appointing a new Chief Executive Officer for the Company. For this purpose, the Board resolved in April 2003 to establish a Board Search Committee. The Members of the Board Search Committee were Chairman of the Nominations Committee

(David Gordon Eldon), then Chairman of the Remuneration Committee (Dr. Raymond Ch'ien Kuo-fung) and Frederick Ma Si-hang. The Board Search Committee held several meetings during the year and made a recommendation on the appointment of Chow Chung-kong as the Chief Executive Officer and a Member of the Board with effect from 1 December 2003, as well as his terms of remuneration.

Code of Best Practice

The Company has complied throughout the year with the Code of Best Practice as set out in Appendix 14 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited ("HKSE") except that non-executive Directors of the Company are not appointed for a specific term but are subject (save for those appointed pursuant to Section 8 of the Mass Transit Railway Ordinance) to retirement by rotation and re-election at the Company's annual general meetings in accordance with Articles 87 and 88 of the Company's Articles of Association. Dr. Raymond Ch'ien Kuo-fung has been a non-executive Director since 1998. He was also appointed non-executive Chairman in July 2003 for a term of three years.

U.S. Sarbanes-Oxley Act 2002

This legislation which seeks to enhance the transparency and accountability of companies in the areas of corporate governance and financial reporting, was signed into law by the President of the United States on 30 July 2002.

As the Company is a U.S. Securities and Exchange Commission reporting company, it is generally bound by this new legislation.

The Company has been, and will continue its process of reviewing its internal systems and practices and implementing new requirements under this legislation in line with applicable compliance dates.

Internal Audit

The Company's Internal Audit Department provides independent, objective assurance and consulting services designed to add value and improve the Company's operations. Key responsibilities of the Department include:

- Assessments on the adequacy and effectiveness of the Company's system of internal control for controlling its activities and managing its risks.
- Identification of opportunities for improving management control, resources utilisation and profitability.
- Special reviews and/or investigations as commissioned by Company management.

The Company's Internal Auditor reports directly to the Chief Executive Officer and has direct access to the Audit Committee.

Business Ethics

The Company is committed to high standard of business ethics and integrity.

The Company is in the process of reviewing the contents of the Code of Conduct to align it with recent developments in corporate governance standards, including corporate governance standards under the Sarbanes-Oxley Act of 2002. Furthermore, the Company is in the process of compiling a new "Corporate Guidebook for All Staff on Code of Conduct", which provides specific guidelines for employees in respect of behaviour within and outside the workplace.

Policies

The Board has adopted risk strategies on the following matters:

- A Construction and insurance;
- B Finance;
- C Treasury risk management;
- D Safety risk management;

E Security management.

No changes to such policies may be made without the approval of the Board of Directors.

Summary Financial Statements

The state of affairs of the Group as at 31 December 2003 and of its results for the year are set out in the summary financial statements on pages 22 to 27.

Ten-Year Statistics

A summary of the results and of the assets and liabilities of the Group together with some major operational statistics for the last ten years are set out on pages 14 to 15.

Fixed Assets and Railway Construction in Progress

Movements in fixed assets and railway construction in progress during the year are set out in Notes 4A and 4B to the summary financial statements respectively.

Movements in Reserves

Movements in reserves during the year are set out in Note 6 to the summary financial statements.

Share Capital

As at 31 December 2002, the authorised share capital of the Company was HK\$6.5 billion, divided into 6.5 billion Ordinary Shares, 5,158,748,655 of which were issued and credited as fully paid. During the year, the Company issued a total of 129,946,738 Ordinary Shares. Of this number:

A 10,489,500 Ordinary Shares were issued by the Company pursuant to the exercise of share options which had been granted under the Company's Pre-Global Offering Share Option Scheme. In respect of each Ordinary Share issued, the relevant exercising share option holder paid HK\$8.44 to the Company;

B 82,018,666 Ordinary Shares were issued by the Company in order to satisfy shareholders' scrip dividend elections in respect of the final dividend of the Company for the year ended 31 December 2002 (for which the cash dividend was HK\$0.28 per Ordinary Share); and

C 37,438,572 Ordinary Shares were issued by the Company in order to satisfy shareholders' scrip dividend elections in respect of the interim dividend of the Company for the six months ended 30 June 2003 (for which the cash dividend was HK\$0.14 per Ordinary Share).

As at 31 December 2003, the authorised share capital of the Company was HK\$6.5 billion, divided into 6.5 billion Ordinary Shares, 5,288,695,393 of which were issued and credited as fully paid.

Redemption of Listed Securities

Neither the Company nor any of its subsidiaries purchased, sold or redeemed any of its listed securities during the financial year 2003.

Donations

During the year, a total of HK\$579,912 was donated, of which HK\$429,912 went to the Community Chest Green Day of Hong Kong.

Internal Control

The Board of Directors is responsible for ensuring that there is in place a satisfactory system of internal control. The main objectives are to ensure adherence to management policies, the safeguarding of assets, the efficiency and effectiveness of operation, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

A function of the Audit Committee is to review the effectiveness of the system of internal control from information provided by the Executive Directorate and management of the Company and by the auditors.

Reporting and Monitoring

There is a comprehensive budgeting system for all operational and business activities, with an annual budget approved by the Board of Directors. Monthly results of the Company's operations, businesses and projects are reported against the budget to the Board of Directors and updated forecasts for the year are prepared regularly.

Treasury Management

The Company's Treasury Department operates within approved guidelines from the Board. It manages the Company's debt profile according to the Preferred Financing Model which defines the preferred mix of financing instruments, fixed and floating rate debts, maturities, interest rate risks, currency exposure and financing horizon. The model is reviewed and refined periodically to reflect changes in the Company's financing requirements and market environment. Derivative financial instruments such as interest rate swaps and cross currency swaps are used only as hedging tools to manage the Group's interest rate and currency risks. Prudent guidelines and procedures are in place to control the Company's derivatives activities, including a comprehensive credit risk management system for monitoring counterparty credit exposure using the Value-at-Risk approach. There is also appropriate segregation of duties within the Company's Treasury Department.

Major financing transactions and guidelines for derivatives transactions including credit risk management framework are approved at the Board level.

Capital and Revenue Expenditure

There are defined procedures for the appraisal, review and approval of major capital and revenue expenditures. All project expenditure over 0.2% of the net assets of the Company and the employment of consultancy services over 0.1% of the net assets of the Company require the approval of the Board.

Bonds and Notes Issued

The Group issued bonds and notes during the year ended 31 December 2003, details of which are set out in Note 5 to the summary financial statements. Such bonds and notes were issued in order to meet the Group's general corporate funding requirements, including the financing of new capital expenditure and the refinancing of maturing debts.

Computer Processing

There are defined procedures and regular quality reviews on the operation of computer systems to ensure the accuracy and completeness of financial records and efficiency of data processing. The Company's computer centre operation and support has been certified under ISO 9001:2000.

Interests in Contracts of Members of the Board and the Executive Directorate

There was no contract of significance, to which the Company or any of its subsidiaries was a party and in which a member of the Board or a member of the Executive Directorate had a material interest (whether direct or indirect), which subsisted at the end of the year or at any time during the year.

Board Members' and Executive Directorate's Interests in Shares

As at 31 December 2003, the interests or short positions of the members of the Board of Directors and the Executive Directorate in the shares, underlying shares and debentures of the Company (within the meaning of Part XV of the Securities and Futures Ordinance ("SFO")) as recorded in the register required to be kept under section 352 of the SFO or as otherwise notified to the Company and the HKSE pursuant to the Model Code for Securities Transactions by the Directors of Listed Companies were as follows:

Ordinary Shares

Member of the Board of Directors or Executive Directorate	Number of Ordinary Shares		Number of Share Options		Percentage of aggregate interests to total issued share capital
	Personal* interests	Family† interests	Personal* interests	Total interests	
T. Brian Stevenson	4,292	–	–	4,292	0.0001
Philip Gaffney	46,467	614	1,022,000 (Note 1)	1,069,081	0.0202
Russell John Black	49,384	–	–	49,384	0.0009
William Chan Fu-keung	46,233	–	822,000 (Note 1)	868,233	0.0164
Thomas Ho Hang-kwong	50,471	2,467	621,000 (Note 1)	673,938	0.0127
Lincoln Leong Kwok-kuen	–	–	1,066,000 (Note 2)	1,066,000	0.0202

Bonds

Member of the Executive Directorate	Personal interests*
William Chan Fu-keung	HK\$101,010 MTR 201 3.75 per cent. Notes due 2004 HK\$50,740 MTR 301 4.50 per cent. Notes due 2005

* Interests as beneficial owner

† Interests of spouse or child under 18 as beneficial owner

Notes

1. Further details of the above share options are set out in the table below showing details of the options to subscribe for ordinary shares granted under the Pre-Global Offering Share Option Scheme.

2. Further details of the above share options are set out in the table on page 21 showing details of the options to subscribe for ordinary shares granted under the New Joiners Share Option Scheme.

Options to subscribe for Ordinary Shares granted under the Pre-Global Offering Share Option Scheme, as referred to in Note 2B(i) to the summary financial statements

Executive Directorate	Date granted	No. of options granted	Period during which rights exercisable (day/month/year)	Options outstanding as at 1 January 2003	Options vested during the year	Options lapsed during the year	Options exercised during the year	Price per share paid on exercise of options (HK\$)	Options outstanding as at 31 December 2003	Weighted average closing price of shares immediately before the date(s) on which options were exercised
Philip Gaffney	20/9/2000	1,066,000	5/4/2001 – 11/9/2010	1,022,000	355,000	–	–	–	1,022,000	–
Russell John Black	20/9/2000	1,066,000	5/4/2001 – 11/9/2010	1,022,000	355,000	–	1,022,000	8.44	–	10.48
William Chan Fu-keung	20/9/2000	1,066,000	5/4/2001 – 11/9/2010	1,022,000	355,000	–	200,000	8.44	822,000	10.38
Thomas Ho Hang-kwong	20/9/2000	1,066,000	5/4/2001 – 11/9/2010	1,021,000	355,000	–	400,000	8.44	621,000	10.43
Leonard Bryan Turk	20/9/2000	1,066,000	5/4/2001 – 11/9/2010	1,022,500	355,000	–	1,022,500	8.44	–	10.61
Other eligible employees	20/9/2000	40,343,000	5/4/2001 – 11/9/2010	30,055,000	10,087,500	1,044,500	6,246,000	8.44	22,764,500	10.03

Notes

1. The Pre-Global Offering Share Option Scheme ("Pre-IPO Option Scheme") shall be valid and effective for a period of ten years after the adoption of the Pre-IPO Option Scheme on 12 September 2000. No option may be offered to be granted on or after the commencement of dealings in shares of the Company on HKSE on 5 October 2000.

2. The number of shares to which the option granted to each participant under the Pre-IPO Option Scheme does not exceed 25% of the number of the shares issued and issuable under the Pre-IPO Option Scheme.

Options to subscribe for Ordinary Shares granted under the New Joiners Share Option Scheme, as referred to in Note 2B(ii) to the summary financial statements

Executive Directorate	Date granted	No. of options granted	Period during which rights exercisable (day/month/year)	Options outstanding as at 1 January 2003	Options vested during the year	Options lapsed during the year	Options exercised during the year	Price per share paid on exercise of options (HK\$)	Options outstanding as at 31 December 2003	Weighted average closing price of shares immediately before the date(s) on which options were exercised
Lincoln Leong Kwok-kuen	1/8/2003	1,066,000	14/7/2004 – 14/7/2013	–	–	–	–	–	1,066,000	–
Other eligible employees	1/8/2003	495,200	14/7/2004 – 14/7/2013	–	–	–	–	–	495,200	–

Notes

1. No option may be exercised later than ten years after its date of offer and no option may be offered to be granted more than five years after the adoption of the New Joiners Share Option Scheme ("New Option Scheme") on 12 April 2002.

2. Unless approved by shareholders in the manner as required by the Rules Governing the Listing of Securities on HKSE, the total number of shares issued and issuable upon exercise of the options granted to any eligible employee under the New Option Scheme together with the total number of shares issued and issuable upon the exercise of any option granted to such eligible employee under any other share option scheme of the Company (including, in each case, both exercised and outstanding options) in any 12-month period must not exceed 1 per cent. of the shares of the Company in issue at the date of offer in respect of such option under the New Option Scheme.

Out of 1,599,000 options granted on 20 September 2000 under the Pre-Global Offering Share Option Scheme to Jack So Chak-kwong, former Chairman and Chief Executive, 1,066,000 vested options remained outstanding as at 1 January 2003. During the year ended 31 December 2003, the remaining 533,000 options were vested and the total 1,599,000 options were exercised and the weighted average closing price of shares immediately before the options were exercised was HK\$10.56.

On 1 August 2003, 1,561,200 options to subscribe for shares of the Company were granted to Lincoln Leong Kwok-kuen, a member of the Executive Directorate, and four other employees under the New Joiners Share Option Scheme. Pursuant to the terms of this Scheme, each grantee undertakes to pay HK\$1.00, on demand, to the Company, in consideration for the grant of the options (the closing market price per share immediately before the date on which the options were granted was HK\$9.25). The share options granted are not recognised in the accounts until they are exercised and the weighted average value per option granted, estimated at the date of grant using the Black-Scholes pricing model, was HK\$1.77 based on the following weighted average assumptions:

Risk-free interest rate	4.82%
Expected life (in years)	5
Volatility	0.24
Expected dividend per share	HK\$0.42

The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options and requires input of highly subjective assumptions, including the expected life and stock price volatility. Because the Company's share options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimates, the Black-Scholes option pricing model does not necessarily provide a reliable measure of the fair value of the share options.

Save as disclosed above:

A none of the members of the Board of Directors or Executive Directorate of the Company had any interest or short position in the shares, underlying shares or debentures of the Company or any of its associated corporations (within the meaning of Part XV of the SFO); and

B during the year ended 31 December 2003, no member of the Board of Directors or Executive Directorate nor any of their spouses or children under 18 years of age held any rights to subscribe for equity

or debt securities of the Company nor had there been any exercises of any such rights by any of them,

as recorded in the register kept by the Company under section 352 of the SFO or otherwise notified to the Company and the HKSE pursuant to the Model Code for Securities Transactions by Directors of Listed Companies.

Substantial Shareholders' Interests

Set out below is the name of the party which was interested in 5 per cent. or more of the nominal value of the share capital of the Company and the respective relevant numbers of shares in which it was interested as at 31 December 2003 as recorded in the register kept by the Company under section 336 of the SFO:

Name	No. of Ordinary Shares	Percentage of Ordinary Shares to total issued share capital
Financial Secretary Incorporated (in trust on behalf of the Government)	4,036,430,908	76.32

Major Suppliers and Customers

Less than 30% in value of supplies (which were not of a capital nature) purchased during the year ended 31 December 2003 was attributable to the Company's five largest suppliers. Less than 30% in value of the Company's turnover during the year ended 31 December 2003 was attributable to the Company's five largest customers combined by value.

Going Concern

The summary financial statements on pages 22 to 27 have been prepared on a going concern basis. The Board of Directors has reviewed the Company's budget for 2004, together with the longer-term forecast for the following five years and is satisfied that the Company has sufficient resources to continue as a going concern for the foreseeable future.

By order of the Board

Leonard Bryan Turk
Secretary to the Board
Hong Kong, 2 March 2004