

# Corporate governance and other information

## Corporate Governance Practices

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 Company has complied throughout the half-year ended 30 June 2006 with the Code Provisions set out in the Code on Corporate Governance Practices (the "Code") contained in Appendix 14 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules") except that, with respect to Code Provision A.4.1, 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 (Cap. 556 of the Laws of Hong Kong) (the "MTR 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. As there are currently nine Directors subject to the requirement to retire by rotation, and one-third of them shall retire at each annual general meeting of the Company (subject to re-election by the shareholders), each of these Directors is effectively appointed for a term of approximately three years. Dr. Raymond Ch'ien Kuo-fung, a Member of the Board, was appointed as the non-executive Chairman of the Company with effect from 21 July 2003 for a term of three years. He was recently re-appointed as the non-executive Chairman of the Company with effect from 21 July 2006 until 31 July 2007.

A person may be appointed as a Member of the Board at any time either by the shareholders in general meeting or by the Board upon recommendation of the Nominations Committee of the Company. Directors who are appointed by the Board must retire at the first annual general meeting after their appointment. A Director who retires in this way is eligible for election at that annual general meeting, but is not taken into account when deciding which and how many Directors should retire by rotation. 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, if the number of Directors is not divisible by three, such number as is nearest to and less than one third) must retire as Directors by rotation.

The Chief Executive of the Hong Kong Special Administrative Region of the People's Republic of China ("HKSAR") may, pursuant to Section 8 of the MTR Ordinance, appoint up to three persons as "additional Directors". Directors appointed in this way may not be removed from

office except by the Chief Executive of the HKSAR. These Directors are not subject to any requirement to retire by rotation nor will they be counted in the calculation of the number of Directors who must retire by rotation. In all other respects, the "additional Directors" are treated for all purposes in the same way as other Directors.

## Model Code for Securities Transactions by Directors of Listed Issuers (the "Model Code")

The Company has adopted the Model Code and, having made specific enquiry, confirms that Members of the Board and the Executive Directorate complied throughout the half-year ended 30 June 2006 with the Model Code set out in Appendix 10 to the Listing Rules. Senior managers who, because of their office in the Company, are likely to be in possession of unpublished price sensitive information, have been requested to comply with the provisions of the Model Code.

## Audit Committee

The Audit Committee meets four times each year with the purpose of monitoring the integrity 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. All the Members of the Audit Committee are non-executive Directors, namely T. Brian Stevenson (chairman), Professor Cheung Yau-kai and the Commissioner for Transport (Alan Wong Chi-kong). Mr. Stevenson and Professor Cheung are also independent non-executive Directors.

## Remuneration Committee

The Remuneration Committee meets regularly to consider remuneration issues, including formulation of a remuneration policy and practices that facilitate the employment of top quality personnel, recommendation to the Board of the remuneration of Members of the Board who are non-executive Directors, determination of the remuneration packages of the Members of the Board who are executive Directors and the Members of the Executive Directorate, and review and approval of performance-based remuneration by reference to the Company's goals and objectives. All the Members of the Remuneration Committee are non-executive Directors, namely Edward Ho Sing-tin (chairman), T. Brian Stevenson and Frederick Ma Si-hang. Mr. Ho and Mr. Stevenson are also independent non-executive Directors.

## Nominations Committee

The Nominations Committee carries out the process of nominating and recommending candidates to fill vacancies on the Board of Directors. 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). Mr. Eldon and Mr. Lo are also independent non-executive Directors.

## Independent Committee

The Board is committed to looking after the interests of independent shareholders of the Company, and for this purpose, an independent committee of the Board (the "Independent Committee") has been established to consider and review the terms of any possible merger between the Company and Kowloon-Canton Railway Corporation, and to advise independent shareholders whether they are fair and reasonable. All the Members of the Independent Committee are independent non-executive Directors, namely Edward Ho Sing-tin (chairman), Professor Cheung Yau-kai, David Gordon Eldon, Christine Fang Meng-sang, Lo Chung-hing and T. Brian Stevenson.

## Internal Control

The Board is responsible for the system of internal controls of the Company and its subsidiaries, setting appropriate policies and reviewing the effectiveness of such controls.

Internal control is defined as a process effected by the Board, Management and other personnel, designed to manage rather than eliminate the risk of failure to achieve business objectives and can only provide reasonable, and not absolute assurance of the following:

- effectiveness and efficiency of operations
- reliability of financial reporting
- compliance with applicable laws and regulations.

Pursuant to the Protocol adopted by the Board, the Board has delegated the day-to-day management of the Company's business to the Executive Committee, and focuses its attention on matters affecting the Company's overall strategic policies, finances and shareholders.

Supported by the Members of the Executive Committee, the Chief Executive Officer who chairs the Executive Committee is responsible to the Board for the conduct of the business of the Company.

The Executive Committee is responsible for implementing the Board's policies on risk and control. In fulfilling its responsibilities, the Executive Committee identifies and evaluates the risks faced by the Company for consideration by the Board and designs, operates and monitors a suitable system of internal controls which implements the policies adopted by the Board. The Executive Committee is accountable to the Board for monitoring the system of internal controls and providing assurance to the Board that it has done so. Additionally, all employees have responsibility for internal controls within their areas of accountability.

Various risk management strategies have been established by the Board as advised by the Executive Committee to identify, assess and reduce risks, including construction, business operations, finance, treasury, safety, security and environmental risks as well as appropriate insurance coverage. In addition to risk management systems and processes that are already in place in each division or department, an Enterprise Risk Management (ERM) framework was recently established for the strategic management of business risks at the corporate level. An Enterprise Risk Review Committee has been formed to oversee the operation of the ERM framework, and the Enterprise Risk Management Department provides technical and coordination support.

Structured cross-discipline processes for the identification, evaluation, ranking and control of risks have been developed. The likelihood and impact of risks within five key areas – finance, safety, business operations, reputation and regulatory – are considered. Risk registers are established and maintained at business unit and corporate levels, and each risk is assigned to a risk owner who is responsible for developing and implementing appropriate risk mitigation measures. The key risks are required to be reviewed at least quarterly at business unit level, half-yearly at executive level and annually by the Board. The Board has reviewed the current risk profile of the Company, and is satisfied that the key risks facing the Company are kept under control and do not represent serious threats to the business, and that suitable risk mitigation measures and review processes are in place.

To ensure the efficient and effective operation of business units and functions, and safety of operating railway and construction works in railway extension projects, Corporate General Instructions (CGIs), divisional and departmental procedures and manuals, committees, working groups and quality assurance units are established to achieve, monitor and enforce internal controls and evaluate their effectiveness.

Control documentations for compliance with Section 404 of US Sarbanes Oxley Act – Internal Control over Financial Reporting, CGIs and various departmental procedures and manuals are established for preventing or detecting unauthorized expenditures and payments, safeguarding the Company's assets, ensuring the accuracy and completeness of accounting records and timely preparation of reliable financial information.

All Department Heads, including Business and Project Managers for overseas projects, are responsible for ensuring the compliance with statutes and regulations applicable to their own functional units. They are required to identify any new or updated statutes, to assess the risk of such statutes and regulations and their impact on the Company's operations, and to review at least once a year that relevant statutes and regulations are complied with.

Members of the Board and Executive Committee, and other nominated managers who have access to price-sensitive and/or specific information are bound by the Model Code for Securities Transactions by Directors of the Listed Issuers. In addition, every employee is also bound by the Code of Conduct issued by the Company, amongst other things, to keep unpublished price-sensitive information in strict confidence.

The Internal Audit Department plays a major role, independent of the Company's management, in assessing and monitoring the internal controls of the Company. The Internal Auditor reports to the Chief Executive Officer and has direct access to the Audit Committee. The Department has unrestricted access to information that allows it to review all aspects of the Company's risk management, control and governance processes. On a regular basis, it conducts audits on financial, operational and compliance controls and risk management functions of all business and support units as well as subsidiaries. Management is responsible for ensuring the control, design and operating deficiencies highlighted from internal audits are rectified within a reasonable period. Internal Audit produces a four-year rolling Audit Plan, based on risk assessment, that is reviewed and approved by the Audit Committee. On a half-yearly basis, the Internal Auditor reports to the Audit Committee his audit findings and his opinion on the system of internal controls.

On behalf of the Board, the Audit Committee evaluates annually the effectiveness of the Company's system of internal controls, including the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. This is achieved primarily through approving the internal audit plan and review the findings of internal audit work, in addition to reviewing the annual and interim financial statements, and the nature, scope of work, and report of the external auditors, and consideration of the following:

- the changes in the nature and extent of significant risks since the previous review and the Company's ability to respond to changes in its business and external environment
- the scope and quality of management's ongoing monitoring of risks and the system of internal control, the work of the Internal Audit Department, and the assurance provided by the Executive Committee
- the extent and frequency with which the results of monitoring are communicated, enabling the Audit Committee to build up a cumulative assessment of the state of control in the Company and the effectiveness with which risk is being managed
- the incidence of any significant control failings or weaknesses that have been identified at any time during the period and the extent to which they have resulted in unforeseen outcomes or contingencies that have had, could have had, or may in the future have, a material impact on the Company's financial performance or condition, and
- the effectiveness of the Company's processes in relation to financial reporting and statutory and regulatory compliance.

The processes for assessing internal controls by the Audit Committee include: regular interviews with Members of the Executive Committee in relation to key business operations, internal control and compliance issues, both financial and non-financial; the review of significant issues arising from the internal and external audit reports, and private sessions with external auditors. The Audit Committee has also reviewed the papers prepared by the Executive Committee and Internal Audit covering: 2005 Annual Report and Accounts, Annual Report on Form 20-F and Reconciliation of 2005 Annual Accounts to US GAAP, Preview of 2006 Interim Accounting issues, 2006 Audit Plan, Internal Audit's Half-yearly Report, Annual Report on Staff Complaints, Reporting of Internal Control Systems, Reporting of Outstanding Litigation and Compliance Issues, Annual Insurance Programme, and Procurement Control and Audit Committee for China Projects. The Chairman of the Committee summarises activities of the Committee and highlights issues arising therefrom by a report to the Board after each Audit Committee meeting.

The Board has, through the Audit Committee, conducted the first review of the effectiveness of the Company's system of internal control for the six-months ended 30 June 2006, covering all material financial, operational and compliance controls and risk management functions, and concluded that adequate and effective internal controls are maintained to safeguard the shareholders' investment and the Company's assets. There were no significant control failings, weaknesses or significant areas of concern identified during the period which might affect shareholders.

## Board Members' and Executive Directorate's Interests in Shares

As at 30 June 2006, the interests or short positions of the Members of the Board 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 (Cap. 571 of the Laws of Hong Kong) ("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 Stock Exchange of Hong Kong Limited ("HKSE") pursuant to the Model Code were as follows:

### Long Positions in Shares and Underlying Shares of the Company

Member of the Board or the Executive Directorate	Number of Ordinary Shares held			Derivatives		Total interests	Percentage of aggregate interests to total issued share capital
	Personal* interests	Family <sup>†</sup> interests	Corporate interests	Share Options	Other		
Chow Chung-kong	–	–	–	–	700,000 (Note 1)	700,000	0.01266
T. Brian Stevenson	4,657	–	–	–	–	4,657	0.00008
Christine Fang Meng-sang	1,701	–	–	–	–	1,701	0.00003
Russell John Black	53,608	–	–	–	–	53,608	0.00097
William Chan Fu-keung	46,960	–	–	217,500 (Note 2)	–	264,460	0.00478
Thomas Ho Hang-kwong	53,513	2,524	–	321,000 (Note 2)	–	377,037	0.00682
Lincoln Leong Kwok-kuen	23,000	–	23,000 (Note 3)	1,043,000 (Note 4)	–	1,089,000	0.01970
Francois Lung Ka-kui	–	–	–	1,066,000 (Note 4)	–	1,066,000	0.01928

#### Notes:

- Chow Chung-kong has a derivative interest in respect of 700,000 shares in the Company within the meaning of Part XV of the SFO. That derivative interest represents Mr. Chow's entitlement to receive an equivalent value in cash of 700,000 shares in the Company on completion of his three-year contract (on 30 November 2006).
- 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.
- The 23,000 shares are held by Linsan Investment Ltd., a private limited company beneficially wholly owned by Lincoln Leong Kwok-kuen.
- 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 New Joiners Share Option Scheme.

\* Interests as beneficial owner

† Interests of spouse or child under 18 as beneficial owner

### Options to subscribe for Ordinary Shares granted under the Pre-Global Offering Share Option Scheme

Executive Directorate and eligible employees	Date granted	No. of options granted	Period during which rights exercisable (day/month/year)	Options outstanding as at 1 January 2006	Options vested during the period	Options lapsed during the period	Options exercised during the period	Exercise price per share of options (HK\$)	Options outstanding as at 30 June 2006	Weighted average closing price of shares immediately before the date(s) on which options were exercised (HK\$)
William Chan Fu-keung	20/9/2000	1,066,000	5/4/2001 – 11/9/2010	317,500	–	–	100,000	8.44	217,500	20.75
Thomas Ho Hang-kwong	20/9/2000	1,066,000	5/4/2001 – 11/9/2010	321,000	–	–	–	8.44	321,000	–
Other eligible employees	20/9/2000	41,409,000	5/4/2001 – 11/9/2010	11,285,000	–	–	3,451,000	8.44	7,834,000	20.00

#### Note:

All of the above share options were vested on 5 October 2003. The proportion of underlying shares in respect of which the share options have vested is as follows:

Date	Proportion of underlying shares in respect of which an option is vested
Before 5 October 2001	none
5 October 2001 to 4 October 2002	one-third
5 October 2002 to 4 October 2003	two-thirds
After 4 October 2003	all

## Options to subscribe for Ordinary Shares granted under the New Joiners Share Option Scheme

Executive Directorate and eligible employees	Date granted	No. of options granted	Period during which rights exercisable (day/month/year)	Options outstanding as at 1 January 2006	Options granted during the period	Options vested during the period	Options lapsed during the period	Options exercised during the period	Exercise price per share of options (HK\$)	Options outstanding as at 30 June 2006	Weighted average closing price of shares immediately before the date(s) on which options were exercised (HK\$)
Lincoln Leong Kwok-kuen	1/8/2003	1,066,000	14/7/2004 – 14/7/2013	1,043,000	–	–	–	–	9.75	1,043,000	–
Francois Lung Ka-kui	27/9/2005	1,066,000	26/9/2006 – 26/9/2015	1,066,000	–	–	–	–	15.75	1,066,000	–
Other eligible employees	1/8/2003	495,200	14/7/2004 – 14/7/2013	400,700	–	–	–	101,500	9.75	299,200	20.78
	12/1/2006	94,000	9/1/2007 – 9/1/2016	–	94,000	–	–	–	15.45	94,000	–
	13/9/2005	94,000	9/9/2006 – 9/9/2015	94,000	–	–	–	–	15.97	94,000	–
	23/9/2005	213,000	9/9/2006 – 9/9/2015	213,000	–	–	–	–	15.97	213,000	–
	17/10/2005	94,000	6/10/2006 – 6/10/2015	94,000	–	–	94,000	–	16.05	–	–
	23/3/2006	94,000	20/3/2007 – 20/3/2016	–	94,000	–	–	–	18.05	94,000	–
	31/3/2006	94,000	20/3/2007 – 20/3/2016	–	94,000	–	–	–	18.05	94,000	–
	12/5/2006	266,500	25/4/2007 – 25/4/2016	–	266,500	–	–	–	20.66	266,500	–
	15/5/2006	213,000	25/4/2007 – 25/4/2016	–	213,000	–	–	–	20.66	213,000	–
	12/5/2006	213,000	2/5/2007 – 2/5/2016	–	213,000	–	–	–	21.00	213,000	–

## Notes:

1. The exercise price of the share options is determined upon the offer of grant of the options and which should not be less than the greatest of (a) the average closing price per share of the Company for the five business days immediately preceding the date of offer of such options; (b) the closing price per share of the Company on the date of offer of such options, which must be a business day; and (c) the nominal value per share of the Company.

2. 94,000 of the share options lapsed during the period.

3. The proportion of underlying shares in respect of which the above share options will vest is as follows:

Date	Proportion of underlying shares in respect of which an option is vested
Before the first anniversary of the date of offer of the option (the "Offer Anniversary")	none
From the first Offer Anniversary to the date immediately before the second Offer Anniversary	one-third
From the second Offer Anniversary to the date immediately before the third Offer Anniversary	two-thirds
From the third Offer Anniversary and thereafter	all

During the six months ended 30 June 2006, 974,500 options to subscribe for shares of the Company were granted to six employees under the New Joiners Share Option Scheme and the respective closing price per share immediately before the respective date of grant of the options are set out below. 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 share options granted are not recognised in the accounts until they are exercised. The weighted average value per option granted, estimated at the respective date of grant using the Black-Scholes pricing model is as follows:

Date granted	Closing price per share immediately before the date of grant (HK\$)	Estimated risk-free interest rate (%)	Expected life (Years)	Estimated Volatility	Expected dividend per share (HK\$)	Weighted average value per option granted (HK\$)
12/1/2006	16.05	4.00	5	0.20	0.42	3.17
23/3/2006	17.60	4.40	5	0.20	0.42	3.25
31/3/2006	17.65	4.47	5	0.20	0.42	3.28
12/5/2006	20.10	4.62	5	0.21	0.42	4.11
15/5/2006	20.10	4.67	5	0.21	0.42	4.13
12/5/2006	20.10	4.62	5	0.21	0.42	3.99

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 or the 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 six months ended 30 June 2006, no Member of the Board 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.

### Substantial Shareholders' Interests

Set out below is the name of the party which was interested in 5% or more of the nominal value of the share capital of the Company and the number of shares in which it was interested as at 30 June 2006 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
The Financial Secretary Incorporated (in trust on behalf of the Government)	4,231,503,767	76.54

The Company has been informed by the Government that, as at 30 June 2006, approximately 1.57% of the shares of the Company were held for the account of the Exchange Fund. The Exchange Fund is a fund established under the Exchange Fund Ordinance (Cap. 66 of the Laws of Hong Kong) under the control of the Financial Secretary.

### Loan Agreements with Covenant Relating to Specific Performance of the Controlling Shareholder

As at 30 June 2006, the Group had borrowings of HK\$31,202 million with maturities ranging from 2006 to 2020 and undrawn committed and uncommitted banking and other facilities of HK\$7,253 million, which were subject to the condition that the Government, being the Company's controlling shareholder, owns more than half in nominal value of the voting share capital of the Company during the lives of the borrowings and the undrawn facilities. Otherwise, immediate repayment of borrowings may be demanded and cancellation of undrawn facilities may result.

### Purchase, Sale or Redemption of Own Securities

Neither the Company nor any of its subsidiaries purchased, sold or redeemed any of its listed securities during the six months ended 30 June 2006.

### Closure of Register of Members

The Register of Members of the Company will be closed from 1 September 2006 to 7 September 2006 (both dates inclusive), during which period no transfer of shares can be registered. In order to qualify for the interim dividend, all transfers, accompanied by the relevant share certificates, must be lodged with the Company's Registrar, Computershare Hong Kong Investor Services Limited at Shops 1712-1716, 17th Floor, Hopewell Centre, 183 Queen's Road East, Wanchai, Hong Kong, for registration no later than 4:00 p.m. on 31 August 2006. The 2006 interim dividend is expected to be paid on or about 27 October 2006 to shareholders whose names appear on the Register of Members of the Company on 7 September 2006.