Executive management's report

> railway operations

The recovery from SARS saw our railway operations resume steady growth. Passenger numbers rose strongly by 8.3% as economic activity returned to normal and the number of tourists from the Mainland sharply increased. The opening of West Rail in December 2003 and the MTR interchange stations also generated an increase in patronage, more than compensating for a slight loss from the opening of KCRC's East Tsim Sha Tsui Station in October.

Patronage

For the year, the MTR Lines recorded total passenger volume of 834 million, against 770 million in 2003. The year also saw the highest patronage recorded on a single, regular 19-hour service day of 2.72 million on 17 December and a record Christmas Eve patronage of 3.38 million passengers. MTR had a 24.8% share of the total franchised public transport market, higher than in 2003, and increased our share of cross-harbour traffic to 59.6%. Fare revenues from operations rose 7.0% to HK$5,417 million.

On AEL, passenger volume rose by 17% to 8.0 million. Average fare rose from HK$62.07 in 2003 to HK$64.25. Fare revenues rose by 21.2% to HK$515 million. However, AEL's estimated market share was 21%, 2% points lower than 2003, reflecting a change in the mix of visitors arriving at and departing from Hong Kong Airport.

Service promotion

The Company launched a series of 25th Anniversary celebration campaigns during 2004, including a special anniversary theme train on the Tsuen Wan Line, TV commercials, one-minute TV segments and participation in TVB Jade's "Hong Kong Superbrands" programme. Hong Kong Station was decorated with a birthday theme, and a lucky draw was conducted. Anniversary ticket sets and supplements were produced. We also continued with fare campaigns emphasising the value for money of MTR services, including "Ride 10 Get 1 Free" and "$2 Holiday Ride" promotions for children and elderly citizens on Sundays and major public holidays, as well as other initiatives. Five fare saver machines were added and five intermodal discount promotions were launched. An online shopping service on the MTR website added a distribution channel for MTR souvenirs and AEL tickets, and the MTR Club's "WOW Fun Scheme" was extended.

For AEL, increased service frequency was extensively advertised and festive promotional campaigns boosted revenue, notably the group ticket plus free child ride during the summer months. Overseas awareness was enhanced through TV programmes in the Mainland and the launch of online advertising in key markets. AEL launched a "Customer Service Ambassadors" programme to establish a continuous presence in the airport arrival area, as well as online ticketing to secure pre-arrival sales of AEL tickets. MTR also partnered with Cathay Pacific Airways to pre-sell tickets in-flight. Marketing partnerships continued with Asia Miles and the Hong Kong Tourism Board.

Service performance

During the year, we maintained our very high standards of reliability, safety, comfort, and customer satisfaction. Regrettably, a number of noticeable, but not safety critical, incidents in the final months gave rise to public concerns over the reliability of our system. The Company established a high-level internal task force to seek operational improvements and commissioned an independent review of processes and assets by international rail expert and validation agency Lloyd's Register Rail. Following the conclusion of the internal task force in November, the Company began initiatives to augment our maintenance regime and incident handling procedures.

The Lloyd's Register Rail report was received in February 2005, which concluded that MTR service performance has seen significant improvement since 2001 and that best practice asset management system is in place across the Company. We have begun taking immediate action to address some of the report's recommendations, and will study the report in detail and set up the necessary organisations and processes to implement its other recommendations.

Our Asset Management Policy stipulates that MTR is committed to the efficient and effective management of our railway assets to ensure that the Operating Agreement and all relevant statutory requirements are complied with. This is achieved through continuous improvement of the asset management processes under the principles of minimising the life cycle costs of assets, maximising their worth to the business and managing the associated risks.

Despite the attention given to these incidents of delay and concern to passengers, for 2004 as a whole the Company continued to exceed the minimum performance levels required by the Government under the Operating Agreement, and the more stringent Customer Service Pledges established by MTR. MTR passenger journeys on time were 99.9%, supported by 99.9% reliability for train service delivery. Escalator reliability was 99.9%. Performance was also excellent in key areas affecting passenger comfort such as temperature, ventilation and cleanliness.

Levels of customer satisfaction recorded by our regular survey remained high. The Service Quality Index for the MTR and AEL stood at 71 and 82 respectively on a 100-point scale. MTR also again performed well according to the 11-member Community of Metros (CoMET) benchmarking report, in the areas of safety, service quality and passenger cost. In addition, MTR won the Top Service Award 2004 – Public Transport from Hong Kong's *Next* magazine for the sixth year running.

The effectiveness of our crisis response was demonstrated in January, when the first ever arson attack took place on an MTR train. The incident was resolved quickly and caused no injury to either passengers or personnel thanks to the rapid and effective response of MTR staff and the calm reaction of passengers. The staff involved were presented with commendation letters by the Secretary for Environment, Transport and Works to recognise their exemplary performance in handling the incident.

MTR maintained a high level of safety throughout 2004 and achieved all safety targets set out in the Corporate Safety Plan. We promoted safe behaviour through educational activities and campaigns including a Safety Web Game, a Safety Carnival and a one-month safety campaign.

Service improvements

The year saw further improvements to MTR's infrastructure and services.

During the year, we opened a new entrance at Kowloon Tong Station connecting the station with the new concourse of KCRC's Kowloon Tong Station, and a new subway system connecting Tsim Sha Tsui Station with the KCRC's East Tsim Sha Tsui Station. Inter-modal fare discounts were extended to 14 feeder routes for travellers transferring to MTR from feeder buses on three New Lantao Bus routes, ten Green Minibus routes and one cross-border bus route. The number of fare saver machines offering discounts to Octopus card holders was increased to 15.

Projects to improve barrier free movement in stations continued, with new passenger lifts installed at Central, Tin Hau and Sai Wan Ho stations. At Tsim Sha Tsui Station, three new escalators were installed.

The project to retrofit platform screen doors at all 30 underground stations remained on schedule. At the end of 2004, these doors were in operation on 56 of the 74 platforms involved in 22 stations, with the project now completed on Tsuen Wan Line, and for stations on the Kwun Tong Line between Yau Ma Tei and Wong Tai Sin. The project was also completed between Sheung Wan and Causeway Bay stations, and at North Point Station, on the Island Line.

Productivity increases

The continuing hiring freeze and increased outsourcing helped MTR to raise productivity during the year, as did other initiatives such as Airport Railway stations assuming responsibility for AEL car park management at Hong Kong, Kowloon and Tsing Yi stations, and installing a new computer system to improve non-traffic hours utilisation. Operating costs per car km decreased 1.8% in 2004 to HK$22.1. Since 1998, operating costs per car km have decreased by 24.3%.

> station commercial and other businesses

The MTR's station commercial and other businesses benefited from the broad economic recovery.

Advertising

Advertising revenue rose 21.0% to HK$467 million, also helped by upgraded advertising venues and more attractive formats.

Spectacular tunnel advertising was introduced between Wan Chai and Causeway Bay stations. A billboard was installed on the external wall at Quarry Bay Station and a Bloomberg display showing real-time financial information was introduced at Hong Kong Station. In December, a plasma ring was launched at Causeway Bay Station, adding a new format to our plasma network. Almost 700 12-sheet advertising panels were installed network-wide.

We commissioned Nielsen Media Research to conduct "Reach & Frequency Research of MTR Advertising", the first survey of its type in Hong Kong's out-of-home advertising market, and the results helped strengthen our media pricing strategy and advertising media planning.

Telecommunications

Revenue from telecommunications, including TraxComm, rose by 20.2% to HK$238 million, thanks to increased mobile phone call volumes. The existing integrated radio system was upgraded to support UMTS standard 3G service provision on the Island Line, making it one of the world's first rail networks to be 3G enabled. TraxComm began operating and managing a 50 Gigabit bandwidth network, serving telecom service operators and extending the fibre-optic network to 26 locations.

Station commercial

Revenue from station commercial facilities increased by 8.4% to HK$298 million. Renovations delivering an additional 1,192 square metres of retail floor area and an enhanced retail environment were completed at Choi Hung, Central, Shau Kei Wan, Tai Koo, Tsuen Wan, Po Lam, Mei Foo, Admiralty and Hong Kong stations. However, with retail space reduced at Kowloon Station for station integration works, the net increase was 268 square metres to reach 18,717 square metres. Renovation works began at Kwai Fong, Sham Shui Po, Yau Ma Tei, Causeway Bay, Wong Tai Sin, Diamond Hill, Lok Fu, Olympic and Tsing Yi stations, and are targeted to complete in the first quarter of 2005.

The Company continued to improve the retail mix, introducing 69 new shops and 28 new trades, including H_2O, Yume, Lo Hang Ka, Q Q Rice, Pie & Tart and TCBY. Sales counters were also introduced in Tseung Kwan O Station for short-term leases to retailers.

External consultancy

The Company currently has consultancy contracts in 22 cities in 11 countries and revenues increased by 27.3% to HK$182 million. During the year, we decided to reorient this business by focusing on smartcard projects and projects likely to lead to investment opportunities.

Together with Octopus and our other partners, we made good progress on the implementation of a national system for the Netherlands. The Design, Build and Test phase is on track for completion in April 2005, when the Company will provide operation support services. We and our partners are focusing on upcoming projects in Melbourne, Toronto and Los Angeles.

MTR's joint-venture subsidiary in Shanghai, Shanghai Hong Kong Metro Construction Management, currently acting as Owner's Representative for Phase 1 of Line 9 of the Shanghai Rail Transit, has helped ensure that this RMB 11 billion (HK$10.4 billion) project made substantial progress towards completion by the end of 2007.

Rail Sourcing Solutions (International) Limited

In August, we established Rail Sourcing Solutions (International) Limited as a wholly-owned subsidiary, to expand into global railway supply and sourcing services.

Octopus Cards Limited (Octopus)

Octopus Cards Limited achieved progress in both the transportation and retail sectors. Its pre-tax profit contribution to the Company increased by 91.3% to HK$44 million. Average daily Octopus card usage rose from HK$50.7 million to HK$57.5 million. Cards in circulation rose from 10.4 million to 11.8 million, while the number of service providers increased from 253 to 299.

Growth in retail usage was driven by the addition of new service providers and full roll out to existing providers. The number of financial institutions participating in the Automatic Add Value Service increased to 19 in 2004 and now includes HSBC, Bank of China, Standard Chartered Bank and Citibank. Overall usage was supported by year-round promotions, including "Rewards on the Go", a monthly lucky draw for frequent card users at retail outlets and car parks.

> international expansion

Mainland of China

Our Mainland investment strategy focuses on major cities of Beijing, Shanghai and Shenzhen where demand for mass transit systems and profit potential is greatest. The Company has adopted a gradual approach, leveraging the experience gained from one project to others.

In January, the Company entered into an Agreement in Principle for a Build-Operate-Transfer project with the Shenzhen Municipal People's Government for the construction of Phase 2 of Line 4 of the proposed Shenzhen Metro System and the operation of the entire line for 30 years. The project will also include property development rights of an aggregate gross floor area of 2.9 million square metres at stations and depot along Line 4.

Line 4 is a 21-kilometre double-track urban railway running from Huanggang, at the boundary between Hong Kong and Shenzhen, to Longhua New Town in Shenzhen, with a total of 14 stations. Total investment in Phase 2 is estimated at approximately RMB 6 billion (HK$5.7 billion). This will be financed by equity capital of RMB 2.4 billion (HK$2.3 billion) with the balance by non-recourse bank loans in RMB. Phase 1 of Line 4 is targeted for full completion before end of 2008. Upon completion of Phase 2 by MTR's project company in late 2008, both Phases 1 and 2 will be operated by MTR.

Since signing the Agreement in Principle, MTR has set up a project office in Shenzhen to undertake preliminary design of the railway and property works and entered into negotiations with the Shenzhen Municipal People's Government on a Concession Agreement and other related agreements which would give the MTR's project company the right to construct Phase 2 and to operate the entire line, together with the right to use the Phase 1 facilities. These agreements are subject to the approval of the Central Government. Planning for property developments associated with the Shenzhen Line 4 project progressed despite a delay in the approval process, and the target completion of the development sites is from 2008 onwards.

After signing a Memorandum of Understanding in April, we entered into an Agreement in Principle with Beijing Infrastructure Investment Co. Ltd (BIIC) and Beijing Capital Group (BCG) in December, to form a Public-Private-Partnership company for the investment, construction and operation of the Beijing Metro Line 4. In February 2005, together with our partners, we initialled the Concession Agreement with the Beijing Municipal People's Government and now await approval from the National Development and Reform Commission. Total investment is approximately RMB 15.3 billion (HK$14.4 billion) of which 70%, land acquisition and civil construction, will be financed by the Beijing Municipal People's Government. The partnership project company will invest approximately RMB 5 billion (HK$4.7 billion) to finance the remaining 30%, comprising provision of trains and related electrical and mechanical systems, and will be responsible for the operation and management of the new line for 30 years.

MTR and BCG will each own 49% of the joint venture company, with BIIC owning the remaining 2%. The joint venture company will seek non-recourse bank loans to finance over 60% of the project with the remainder to be funded by equity capital. This new 29-kilometre underground line will run from Majialou Station on the South Fourth Ring Road to the north western Haidian District and terminate at Longbeicun Station, forming a main north-south traffic artery of Beijing.

Europe

Our growth strategy in Europe focuses on train operation franchises, which do not require significant capital expenditure. MTR will seek joint-venture partnerships with experienced local firms to bid for operation and maintenance franchises and contracts.

In November, we signed a joint-venture agreement with the UK's Great North Eastern Railway Holdings Limited to bid for a service contract to operate and maintain trains for the Integrated Kent Franchise (IKF). MTR owns 29% of the joint-venture company. IKF is a suburban commuter network in Kent, operating through 179 stations, 1,600 rail cars and with annual revenue of about £300 million. It includes the high-speed railway service from the Kent Coast to London operating over the Channel Tunnel Rail Link.

Since December, MTR has been working to pursue a similar opportunity for the Thameslink / Great Northern Franchise, which serves London north and south of the River Thames.

> property business

In 2004, MTR's property businesses benefited from a sustained recovery and growth in the Hong Kong property market, inbound tourism and an improved economy.

Property development

Property development profit was HK$4,568 million, a decrease from 2003, when we recognised as income the receipt of our share of floors in Two IFC.

Airport Railway

Along the Airport Railway, profit contributions came from the receipt of part of the Union Square retail shell structure at Kowloon Station. Other contributors included our share of surplus proceeds from The Harbourside, and recognition of deferred income from Tung Chung Packages Two and Three (Coastal Skyline and Caribbean Coast), and The Harbourside.

Sales and pre-sales of properties benefited from the strong property market. Sales of luxury apartments at The Harbourside achieved very satisfactory results. The pre-sale of Caribbean Coast Towers 9 and 11 met with a very good response. The sale was launched of the 392 units at Coastal Skyline Tower 2 of Tung Chung Package Two.

The Company and our developers continued to work with the Government and the Town Planning Board to refine future development plans, to take advantage of market developments. A revised Master Layout Plan for Tung Chung Package Two, Coastal Skyline, was approved by the Town Planning Board, providing more open space by reducing the number of low-rise developments. At Tsing Yi, the Town Planning Board took forward our proposed part-conversion scheme to change the lorry park to retail use through a land use rezoning.

At Kowloon Station, a review of the construction programme and design for Union Square Packages Five, Six and Seven was undertaken by the developer, which may delay completion of the Landmark Tower development to 2010.

Tseung Kwan O Line

Along the Tseung Kwan O Line, development profit was derived from Residence Oasis at Hang Hau Station. Sales of residential units of Residence Oasis were very satisfactory and pre-leasing progressed well for the associated 3,500-square metre shopping centre, "The Lane".

Pre-sale consent for Area 57a was obtained and the developer is expected to launch sales in early 2005. Pre-sale consent for Area 55b is planned and should be granted in early 2005.

At Area 86, location of the Tseung Kwan O Line depot and future Tseung Kwan O South Station, approval was granted for a substantial revision to the Master Layout Plan for the "Dream City", which greatly enhanced the garden city and pollution-free concept. The tender for Package One of Area 86 was awarded in January 2005.

The Company also submitted a planning application for Area 56 to the Town Planning Board in January 2005, to convert the site to a more commercially viable mixed-use development.

Investment properties

The continuing economic recovery increased revenue from investment properties by 11.9% to HK$994 million. The primary drivers were higher renewal rents, favourable turnover rental, better promotional counter income and higher rental income from Two IFC.

We again achieved 100% occupancy at our shopping centres, Telford Plaza, Maritime Square, Luk Yeung Galleria and Paradise Mall. Several large new tenants signed during 2004. IKEA opened its largest 7,800 square metres store in Kowloon at Telford Plaza. Demand for space at Two IFC continued to grow. By year end, 100% of MTR's 18 floors were leased. At year end, MTR's investment property portfolio totalled 176,020 square metres

Property management and others

The year saw steady growth in the MTR's property management portfolio, leading to a 14.9% rise in revenues from property management to HK$108 million. During the year, 2,368 units were added to the portfolio: 854 from Sorrento, 1,122 from The Harbourside, and 392 from Coastal Skyline. As a result, by year end MTR had 49,283 residential units and 558,796 square metres of commercial and office space under management.

Revenue from property agency was stable at HK$6 million. The MTR's Octopus Access Control business continued to expand, with annual turnover increasing by 19% to HK$10 million. In the Mainland, Octopus Access Control was adopted by Shanghai Hong Kong Metropolis, a high-end serviced apartment and commercial complex located in Shanghai's Central Business District and to be completed in 2008.

Business in the Mainland

MTR's expertise continued to translate into Mainland contracts for pre-management advisory and property management. Currently, MTR has more than 800,000 square metres of residential and commercial space under pre-management contracts and some 422,000 square metres of residential and commercial space under property management contracts.

> future Hong Kong projects

MTR made further progress on projects to expand and enhance our rail-property infrastructure in Hong Kong, while ensuring project plans are sensitive to the environment and economically sound.

We are working to ensure completion by 1 July 2005 of the Disneyland Resort Line, which will connect the theme park with the MTR network. Construction of the Tai Yam Teng Tunnel was completed. Architectural and builders works, and installation of electrical and mechanical equipment were substantially completed for both Disneyland Resort Station and Sunny Bay Station. Automatic platform gates have been installed and conversion of rolling stock completed.

Construction work began on the Tung Chung Cable Car project. Mules were imported to transport materials in the Country Park. Construction of the Tung Chung and Ngong Ping terminals progressed well and work started on the Theme Village. Completion of the project by early 2006 remains on track.

In February, we submitted to the Government proposals for an extension of the Kwun Tong Line from Yau Ma Tei Station to Whampoa Gardens. Consultants were asked to prepare detailed design proposals for Tseung Kwan O South Station located within the future "Dream City", which will be completed in 2009.

In January 2003, the Government requested MTR to proceed with planning for the West Island Line and the South Island Line. In March 2004, MTR submitted revised proposals to the Government. The proposals contain three elements: an extension of the high capacity Island Line to serve Western District; and two medium capacity lines to serve the south side of Hong Kong Island. One of the medium capacity lines would interchange with the Island Line at Admiralty Station and serve Ocean Park, Wong Chuk Hang and Ap Lei Chau. The other would interchange with the Island Line extension in Western District and serve locations such as Cyberport, Wah Fu and Aberdeen, terminating at the Wong Chuk Hang interchange station. Discussions continue with the Government on the scope and programme for these new lines.

Work proceeded on schedule for the new AsiaWorld-Expo Station at the end of AEL at Hong Kong International Airport that will serve the AsiaWorld-Expo. It is scheduled for completion by end 2005.

The Company continues discussions with the Airport Authority over plans to expand the facilities at Airport Station to connect to the Authority's new Skyplaza development.

In January, developer funded construction began on the new Queensway subway that will connect Three Pacific Place with Admiralty Station, with completion scheduled by the end of 2005.

> human resources

We continued to work closely with our skilled, talented and committed employees to ensure their continuing support. A hiring freeze in line with our productivity drive remained in force and this has resulted in our total staff number declining to 6,555 from 6,629 in 2003. Turnover per operating railway employee increased from HK$1.27 million in 2003 to HK$1.40 million.

The Company's new Vision, Mission and Core Values were actively communicated to all staff. 134 workshops designed to help align the Company's culture and values with our Hong Kong and overseas business strategies were held. We also worked to ensure open and transparent communication with employees about the possible merger with KCRC and its potential implications.

A number of initiatives were developed in response to employee concerns raised in the 2003 Staff Attitude Survey. "Meet the CEO" and "Meet Senior Management" programmes were initiated to improve staff and senior management communication.

Specific programmes were also developed to help managers and supervisors improve their leadership skills. In addition, over 1,300 supervisory staff participated in a "New Horizon for Supervisors" training programme.

To support the Company's overseas business development, MTR's Human Resource Management Department provided professional advice and personnel support to line managers and staff on overseas assignments. In meeting the challenges posed by overseas expansion, MTR has also implemented a just-in-time manpower resourcing strategy. This includes building a dedicated resource pool to grow the business, backed by customised remuneration and employment terms, comprehensive human resources policies and systems, as well as training and development initiatives.

For the third consecutive time, MTR received the Hong Kong Labour Department's Good People Management Award. The Operations Training Department gained ISO9001, ISO14001 and OHSAS18001 accreditations for its Integrated Management System. The Company also received the HKMA's "Most Innovative Award" and a "BEST Award" from the American Society for Training and Development.

> financial review

Review of 2004 financial results

Profit and loss

Total patronage for the MTR Lines increased significantly from 770 million to 834 million. Average weekday patronage improved to 2.40 million from 2.24 million. MTR's overall share of total franchised public transport rose to 24.8% from 24.3%, while the cross-harbour market share increased from 58.7% to 59.6%.

Total fare revenue for the MTR Lines increased 7.0% to HK$5,417 million. With a higher proportion of passengers using concessionary tickets and an increase in free-ride tickets issued through the "Ride 10 Get 1 Free" promotion campaign, the average fare dropped slightly to HK$6.50.

Average daily patronage on AEL rose by 16.6% to 21,800, while our estimated market share of airport passengers reduced from 23% to 21%. Total revenue from AEL increased by 21.2% to HK$515 million, with the average fare improving from HK$62.07 to HK$64.25 in 2004.

Non-fare revenue grew strongly to HK$2,419 million, comprising HK$1,311 million from station commercial and other revenue and HK$1,108 million from property rental and management. Station commercial and other revenue grew 17.4% mainly due to advertising and telecommunication income. Property rental and management income increased by 12.1%, mainly attributable to a full year of operation of Two IFC, an expanded portfolio of managed properties, higher rental renewal rates, and the removal of SARS rental concessions.

Despite a general increase in business activities, operating expenses before depreciation decreased 1.1% to HK$3,805 million and staff costs were reduced from HK$1,643 million to HK$1,542 million, mainly due to lower pension expenses. There was also a HK$69 million write-back of property revaluation deficit on our head office building made in 2003. These were partly offset by higher Government rent and rates, higher maintenance costs of HK$517 million, and higher project study and business development costs .

Operating profit from railway and related operations before depreciation and interest amounted to HK$4,546 million, an increase of 21.3%. Operating margin was 54.4% compared with 49.3% in 2003.

Profit on property development was HK$4,568 million compared with HK$5,369 million, comprising mainly sharing in kind for part of Kowloon Station's Union Square retail shell structure, recognition of deferred income relating to Caribbean Coast and Coastal Skyline at Tung Chung Station and The Harbourside at Kowloon Station, and surplus proceeds from the Harbourside at Kowloon Station and Residence Oasis at Hang Hau Station in Tseung Kwan O.

Operating profit before depreciation was HK$9,114 million, almost the same as in 2003. Depreciation charges increased by 4.6% to HK$2,512 million from HK$2,402 million, mainly due to a full year's depreciation in respect of the West Rail Interchange facilities following its commissioning in December 2003, and depreciation on new railway assets.

Net interest expenses decreased to HK$1,450 million due to lower interest rate environment and reduced borrowings. The average interest rate reduced to 4.7% while the interest cover increased to 6.1 times.

The Company's share of Octopus Cards Limited's pre-tax earnings was HK$44 million. Income tax expenses decreased by 6.4% to HK$700 million, mainly due to a HK$300 million deferred tax adjustment on an increase in the Profits Tax rate in 2003, which was partly offset by higher deferred tax expense on the 2004 property development profit. As a result, the Group's profit attributable to shareholders for the year was HK$4,496 million, an increase of 1.0%. Earnings per share decreased slightly from HK$0.85 to HK$0.84 owing to new shares issued.

The Board recommended a final dividend of HK$0.28 per share, amounting in total to HK$1,509 million. The Government has agreed to receive its entitlement to dividends in the form of shares to the extent necessary to ensure a maximum of 50% of MTR's total dividend will be paid in cash.

Balance sheet

The Group's balance sheet remained strong, with the bulk of assets invested in the railway system. Total fixed assets increased from HK$96,921 million to HK$100,313 million as at 31 December 2004, mainly attributable to receipt of the shell structure of a retail centre and surpluses in investment property revaluation.

Railway construction in progress increased to HK$962 million as at 31 December 2004, due to additional capital expenditures on the Disneyland Resort Line, Tung Chung Cable Car and AsiaWorld-Expo Station projects. Property development in progress at the year end decreased by 9.6% to HK$2,088 million, mainly due to the transfer of development costs of Hang Hau property development project upon its completion out of the account.

Cash and cash equivalents decreased to HK$269 million as at 31 December 2004 from HK$376 million as at 2003 year end.

Total loans outstanding at year end were HK$30,378 million, a decrease of HK$1,647 million due to loan repayments. Loans drawn down amounted to HK$7,194 million which were primarily for refinancing purposes.

Deferred income decreased to HK$4,638 million following profit recognition at Tung Chung and Kowloon station developments based on progress of property construction and pre-sales programmes. This was partly offset by an increase in the transfer-in of deferred income in respect of the retail shell structure at Kowloon Station.

Our share capital, share premium and capital reserve of HK$36,269 million at year-end was HK$1,183 million higher than in 2003, as a result of shares issued for scrip dividend and share options exercised. Together with increases in property revaluation reserves of HK$2,759 million and retained earnings net of dividend of HK$2,265 million, total shareholders' funds increased to HK$63,499 million from HK$57,292 million. As a result, the Group's gross debt-to-equity ratio improved from 55.9% to 47.8% at 2004 year-end and net debt-to-equity ratio from 55.2% to 47.4%.

Cash flow

Net cash inflow generated from railway and related activities increased to HK$4,486 million, while cash receipts from developers for property development projects increased from HK$855 million to HK$2,576 million. Outflows for capital project payments and interest expenses amounted to HK$2,889 million and HK$1,301 million respectively, compared to HK$2,670 million and HK$1,643 million. Together with other minor movements, net cash flow before dividends and loan repayments were HK$2,566 million, HK$2,109 million higher. After dividend payments of HK$1,079 million and net loan repayment of HK$1,593 million, there were net cash outflows of HK$106 million compared to HK$1,320 million.

Revised accounting standards in 2005

Following the convergence of the Hong Kong Accounting Standards with the International Accounting Standards from 1 January 2005, the accounting standards in Hong Kong have been substantially revised and the Company's future financial statements and results will be affected by these changes, notably those relating to valuation of investment properties and financial instruments. Previously, changes in the fair value of investment properties arising from revaluation had been generally recognised through the reserve account on a portfolio basis without impacting the Profit and Loss Account (P&L). However, after 1 January 2005, these revaluation gains or losses are required to be brought through the P&L. With the volatility of property prices being a characteristic of the Hong Kong market, this new accounting standard could have a significant impact on the level and consistency of our reported profit.

The new accounting standard relating to financial instruments requires that after 1 January 2005 all financial instruments which the Company is using to hedge the interest rate and currency risks of our borrowings must be marked to market, with any change in their fair values recognised in the P&L directly. However, the standard allows the application of hedge accounting, that is, to use the change in fair value of the underlying hedged items to offset this impact so that only inefficiency in the hedging relationship resulting in net residual impact will be reported in the P&L. Given that hedge efficiency is affected by a number of factors including the nature of the hedging relationship, direction of interest rates and changes in foreign exchange rates, it is difficult to forecast and control this residual impact.

It should be stressed, however, that both these items are non-cash items and hence do not affect cash flow. The revised standards also introduced a number of other minor changes, mainly on alignment of disclosure with the international standards, which will be reflected in the 2005 accounts.

Financing activities

New financings

In January, the Group took advantage of favourable market conditions and successfully launched a US$600 million 10-year fixed rate bond. The offering attracted total subscriptions of almost US$1.9 billion from over 130 accounts. Carrying a coupon rate of 4.75%, the bond was priced at an attractive re-offer spread of 83 basis points over 10-year treasuries. The transaction not only extended our debt maturity profile but also established a new benchmark for Hong Kong's quasi-sovereign credits. This was later in the year supplemented by a HK$200 million 12-year and HK$300 million 15-year bond. At the end of 2004, the Company had total undrawn committed facilities amounting to HK$5.8 billion, sufficient to cover all of our expected funding needs into the second quarter of 2006.

Cost of borrowing

The attractive terms of the new financings together with prevailing low interest rates enabled the Group to further lower overall borrowing cost to 4.7% from 5.1%, and to reduce gross interest expense by HK$149 million.

Risk management

The Company continued to undertake fund raising activities and manage our debt portfolio in accordance with the Preferred Financing Model. As a result, the Company maintained a balanced debt profile with adequate risk diversification and sufficient coverage of anticipated future funding needs. The Company uses derivatives solely for hedging purposes.

Credit ratings

Moody's re-affirmed the Company's short-term foreign currency rating and long-term domestic/foreign currency ratings at respectively P-1 and Aa3/A1 with a stable outlook. Standard & Poor's also affirmed our ratings at A-1+/A-1 and AA-/A+ for short-term local/foreign currency and long-term local/foreign currency borrowings respectively with a negative/stable outlook respectively on the local and foreign currency ratings, with the negative outlook on local currency subsequently revised to stable. R&I also re-affirmed the Company's short-term local currency and long-term domestic/foreign currency ratings at respectively a-1+ and AA/AA-.

Financing capacity

Our current committed capital expenditure programme comprises mainly the maintenance and upgrade of the existing lines, 50% land premium of Tseung Kwan O Area 86 Package One, and the construction of the Disneyland Resort Line and Tung Chung Cable Car. Capital expenditure programme for the next three years is therefore expected to be modest, with a budget of around HK$6.8 billion. MTR thus has financing capacity to take advantage of any new investment opportunities.

The estimated total investment of RMB 6 billion (HK$5.7 billion) for Shenzhen Line 4 will be funded 40% by equity and 60% by non-recourse bank loans in Renminbi. MTR's investment in Beijing Line 4 will be represented by our 49% shareholding in the PPP company which is responsible for the trains and related electrical and mechanical systems which are estimated at RMB 5.0 billion (HK$4.7 billion). It is planned that more than 60% of the investment by the PPP company will be funded by non-recourse bank loans in Renminbi with the balance financed by equity capital. MTR's equity investment in the PPP company therefore is estimated at around RMB 735 million (HK$693 million). We anticipate that MTR's total equity investment of slightly above RMB 3 billion (HK$2.8 billion) in these two projects will be financed by a combination of internally generated funds and external borrowing by the Company.

The capital structure and funding alternatives for the SIL and WIL as well as the Kwun Tong Line extension, in respect of which MTR submitted proposals to the Government, will be examined at a later stage if and when Government approvals are obtained.