

# Executive management's report

## Railway operations

Total fare revenue increased by 5.9% over 2004 to HK\$6,282 million, reflecting growth in patronage due to economic growth, the opening of DRL and improvements in service quality and station environments, as well as higher average fares for the MTR Lines and AEL.

### Patronage

On the MTR Lines, total patronage reached a record high of 858 million, 2.9% higher than 2004. Average weekday patronage increased by 3.9% to 2.5 million. Our share of the total franchised public transport market rose to 25.2% from 24.8%, with our share of cross-harbour traffic rising to 61.2% from 59.6%. As a result, fare revenue rose to HK\$5,721 million, 5.6% higher than in 2004.

For AEL, passenger volume rose 6.0% to 8.5 million in 2005, as the number of air travellers using Hong Kong International Airport increased. Average daily patronage rose 6.4% to 23,300, with our estimated market share of passengers travelling to and from the airport increasing to 22% from 21%. As a result, fare revenue rose 8.9% to HK\$561 million.

### Network expansion

DRL and Disneyland Resort Station were opened to the public in August, and Sunny Bay Station, the interchange station with the Tung Chung Line was opened in June. The performance of the DRL has since exceeded reliability performance targets.

In December, AEL service was extended to the new AsiaWorld-Expo Station to serve Hong Kong's newest international exhibition centre at the Airport.

### Service and promotional campaigns

Programmes throughout the year raised awareness of our service quality and supported patronage growth. These included a Best Station Operator Election for all MTR and AEL stations, a television commercial and a series of advertorials and in-station publicity.

With year-end membership exceeding 500,000, the MTR Club was leveraged to good effect, with a new bonus point scheme to replace the "Ride 10 Get 1 Free" scheme, a major recruitment campaign accompanied by a Chinese name competition, and a Christmas Fun Day to reward loyal members.

To support the opening of DRL, TV commercials, print advertisements, extensive publicity in stations and a special countdown display at Hong Kong Station were launched, followed in December by extending sales of special DRL 1-day passes at all MTR and AEL stations.

The Company's "MTR - Metro News version" TV commercial won "The Most Delightful TV Commercial Award" at ATV's 11th Annual Most Popular TV Award Presentation.

The strategy to improve linkage with other modes of transport is critically important to increasing our market share, and in 2005 the number of feeder bus routes offering inter-modal fare discounts was increased to 25 from 14, whilst the number of fare saver machines offering discounts to Octopus card holders rose by four to 19.

A series of Doraemon Child Ticket sets was launched for AEL during Easter, the summer months, Christmas and Chinese New Year holidays, to target leisure travellers, and this has resulted in incremental network usage.

The Airport Express "Ride to Rewards Programme" was launched to target business travellers, the core target market segment of AEL, supported by in-station publicity, on-line advertisements, emails to MTR Club members and on-site recruitment. By the end of the year, some 9,000 members have signed up for the Programme.

To support the opening of the new AsiaWorld-Expo Station, a series of pre-launch activities was launched, followed by an advertising campaign during launch to promote local and overseas usage, as well as special tickets for sale via AsiaWorld-Expo to secure overseas pre-arrival sales.

### Service performance

During 2005, MTR Corporation maintained its very high standards of reliability, safety, comfort and customer satisfaction.

For the sixth consecutive year, the Company exceeded, in every area, the Government's requirements under the Operating Agreement, and its more stringent Customer Service Pledges. For the year, passenger journeys on time for MTR Lines were 99.9% reliable, supported by 99.9% reliability for train service delivery.

Customer satisfaction remained high with the Service Quality Index for MTR and AEL at 71 and 81 respectively on a 100-point scale. The Company again performed well according to the international 12-member Community of Metros (CoMET) benchmarking results for service reliability, asset utilisation and cost efficiency.

In Hong Kong, the Company won *East Week Magazine's* first ever "Quality Living Award HK 2005" - Public Transport Category and, for the seventh year in a row, *Next Magazine's* "Top Service Award 2005" - Public Transport.

The China Association for Quality awarded the Company the "China National Quality Management Award" for 2005, its highest award for quality management and customer service. Overseas, we were named runner-up of the "Robert W. Campbell Award" for success in integrating safety, health and the environment into our operations.

Having further enhanced its world class asset management system in 2005, the Company was recognised with the award of the PAS 55-1:2004 Asset Management Certification by the internationally respected certification body Det Norske Veritas.

### Service improvements

During the year, we continued to make improvements to the network infrastructure and services, including completion of convenient new pedestrian links for access to stations at Tsim Sha Tsui, Mong Kok and Kwun Tong.

Over the last 10 years, the Company has invested more than HK\$400 million in facilities for the disabled. In 2005, new passenger lifts were installed at Sheung Wan and Jordan stations, while portable ramps to assist wheelchair passengers to access trains were introduced at all MTR and AEL stations. A further HK\$100 million will be spent in the next five years on stairlifts, audible devices on escalators and passenger lifts.

The project to retrofit platform screen doors at all underground stations was substantially completed in 2005, with installation at 18 platforms in stations at Diamond Hill, Choi Hung, Lam Tin, Tin Hau, Fortress Hill, Quarry Bay, Tai Koo, Sai Wai Ho and Sau Kei Wan. Final completion of the programme is expected in the first quarter of 2006.

The eight years old station improvement programme has progressed further, bringing a fresher and more modern appearance to eight more stations at Lok Fu, Kowloon Bay, Diamond Hill, Kwai Fong, Sham Shui Po, Yau Ma Tei, Olympic and Tsing Yi, and the total number of renovated stations to 38.

In anticipation of higher patronage due to opening of the AsiaWorld-Expo Station, the entire fleet of AEL trains was modified from a 7-car to an 8-car configuration to increase capacity. In addition, four new trains were ordered,

the first due to enter service in mid 2006, to meet increasing passenger demand on the Tung Chung Line.

## Productivity

The Company continued its efforts to increase productivity.

A new risk based approach in determining maintenance needs was introduced, using techniques such as reliability centred maintenance to

control maintenance cost. However, as a result of higher staff costs and further enhancement to our assets, maintenance and asset management system in response to the public concerns in 2004, operating cost per car kilometre rose by 2.2% to HK\$22.8 in 2005.

During the year, we also conducted trials on automated train door operation, which may be introduced in future depending on trial results and further tests.

# Station commercial and other businesses

Station commercial and other businesses achieved revenue growth of 18.6% over 2004 to HK\$1,555 million on the back of a strong economy, increasing patronage and higher consultancy revenue, supported by our strategy to leverage our railway assets to expand non-fare revenue.

## Advertising

During the year, advertising revenue increased 9.2% to HK\$510 million as a result of a strong retail sector, our further improved and refined advertising formats, as well as favourable response to our new advertising packages tied to the opening of DRL.

We introduced a number of new advertising formats, including audio advertising at 15 locations in six stations along the MTR Lines, and facilities for platform bunting (decorative flags) at six stations. We also installed lit-up billboards above entrances at Mong Kok and Tsim Sha Tsui stations.

Improvements to existing formats were also introduced, including enlarged advertising cards offering greater visual impact in some 106 trains on the Island, Kwun Tong, Tsuen Wan and Tseung Kwan O lines.

To provide better viewing quality and simplify operation, 18 plasmas at the e-Instant Bonus terminals were replaced and their content management system was integrated with the concourse plasma network.

## Telecommunications

Revenue from telecommunications services increased by 40.3% to HK\$334 million, the bulk of which however was attributable to a one-off settlement from early termination of a telecommunication service agreement.

In October, upgrading of the existing radio network to enable seamless 3G service provision by all 3G operators across the MTR network was completed, six months ahead of schedule.

TraxComm Limited recorded higher revenues as it expanded its presence, extending its optical fibre network to 30 locations whilst increasing the capacity of its bandwidth services to 80Gbps.

## Station commercial

Station commercial facilities revenue rose by 15.4% to HK\$344 million, boosted by higher rental rates and the expansion of retail space under the station renovation programme.

During the year, renovations were completed in the retail zones of 20 stations, bringing the total number of stations having undergone renovation to 30. Allowing for repossession of retail area of 1,690 square metres in Kowloon Station to facilitate integration works with Union Square, this has increased our total retail floor area by 2% to 19,070 square metres, with 99 new shops and 28 new trades or brands added at the same time. Renovation work also began at two more stations.

Miscellaneous business revenue, including car park rental, souvenir ticket sale, new station connections and publication, increased by 23.8% to HK\$156 million.

## External consultancy

In external consultancy, our strategy remains to focus on consultancies that

may lead to investment opportunities. In 2005, revenue from this business increased to HK\$211 million.

In the Mainland of China, several new consulting and training contracts were signed. Line 9 Shanghai Rail Transit project management consultancy work progressed well. By year-end, construction works were 38% complete. In Shanghai, we completed study packages for Line 11 Phase 1 (North) and have signed a further contract for Line 11 Phase 2 (South).

In Asia, we secured more than 30 new contracts including a contract with Kaohsiung Rapid Transit Corporation. In Hong Kong, the Automated People Mover system maintenance contract for the airport was renewed for three years and we are working on an extension of the system to SkyPlaza and the SkyPier. Elsewhere, we have completed work for the Macau Government, the Taiwan High Speed Rail Corporation and Nippon Sharyo Limited.

## Rail Sourcing Solutions (International) Limited

Our wholly-owned subsidiary Rail Sourcing Solutions (International) Limited continued to expand its presence in the global railway parts and equipment market and is now active in the UK, Europe, North America and Australia.

## Octopus Holdings Limited

As part of a corporate re-organisation, Octopus Holdings Limited (OHL) was established as the holding company for the Octopus group of companies, including Octopus Cards Limited (OCL). The shareholding structure remained unchanged, with MTR Corporation continuing to own 57.4% of the group through OHL. MTR Corporation's share of earnings from OHL was HK\$40 million, an increase of 2.6% over 2004.

During the year, the number of service providers rose to 349 from 299. Cards in circulation and average daily transaction value have respectively risen to 13.2 million from 11.8 million, and to HK\$64.7 million from HK\$57.4 million.

By year-end, green minibuses accepting the Octopus rose by 103 to 2,747, representing virtually the entire fleet, whilst red minibuses accepting Octopus card increased from 50 to 171. A further 37 car parks joined the system, bringing the total to 203. Octopus cards are now in use on all cross-border buses and coaches.

In the retail sector, in addition to fast food chains, supermarkets, convenience stores and cake shops, Octopus card system also gained entry into the clothing, telecommunications and the government sectors.

During the year, a customer loyalty programme was launched, which by year-end had attracted participation of over 590,000 cardholders.

In August, OCL reached agreement with the Hong Kong Monetary Authority on a new regulatory framework for supervision of multi-purpose stored value card operation, resulting in the relaxation of some of the restrictions on Octopus cards in non-transport markets.

Despite these successes and the on time delivery of the Octopus clearing house system for the nationwide Automatic Fare Collection project in the Netherlands, OHL group's consolidated profit registered only a modest increase because of increase in operating costs due to the development and start-up of new businesses, particularly the customer loyalty programme.

## Overseas growth

MTR Corporation made significant strides in its international expansion.

### Mainland of China

During 2005, the Company achieved a number of major milestones on its RMB6 billion project to build Phase 2 of the Shenzhen Metro Line 4 and to operate both Phase 1 and Phase 2 of the line for 30 years. The feasibility study report was submitted to NDRC, and the Concession Agreement was initialled between the Company and the Shenzhen Municipal Government. Detailed design work and ground breaking on a trial section began.

Bank financing for the project, approximately 60% of the total project cost, was secured in June when a term sheet for a RMB3.6 billion 25-year non-recourse loan was initialled between the Company and China Development Bank.

In Beijing, the PPP company 49% owned by MTR Corporation, 2% by Beijing Infrastructure Investment Co. Ltd. and 49% by Beijing Capital Group through its partner initialled the Concession Agreement with the Beijing Municipal Government for investment in, construction and operation of the 29-kilometre Beijing Metro Line 4 for 30 years.

With an estimated total investment of RMB15.3 billion, the project involves investment of approximately RMB4.6 billion, or 30% of total project cost by the PPP company, with the remaining 70% by the Beijing Municipal Government.

Formal approval was obtained from NDRC and the Joint Venture Agreement and Company Articles of Association were approved by the Ministry of Commerce, followed by issuance of a business license by the State Administration of Industries and Commerce, thus completing all company registration requirements. Preparation work was initiated.

The RMB4.6 billion investment by the PPP company will be financed by 30% equity provided by the partners and 70% by bank debt in the form of two RMB1.6 billion 25-year non-recourse bank loans from the Industrial and Commercial Bank of China and China Development Bank, agreements for which were initialled by the PPP company partners during the year.

Two MOUs were signed. The first was with the Shenzhen Municipal Government covering co-operation on investment, construction and operation for the 32.9-kilometre Line 3. Significant progress has since been made in negotiations.

The second was signed with the Wuhan Urban Construction Investment and Development Group Co. Ltd. and Wuhan Municipal Development Planning Commission covering the development of the metro network in Wuhan. A pre-investment study is underway and discussions continue.

### Europe

The Company's approach in Europe is to bid for operating franchises involving both heavy rail and metro.

In 2005 the Company participated in unsuccessful bids for one franchise in Sweden and two in the UK. Presently, it is exploring opportunities in the UK and Scandinavia, particularly operations contracts which the UK Government has announced will be reorganised and refranchised.

In the UK, MTR Corporation and its partner GNER have pre-qualified for a bid for the South Western Trains Franchise. We are also in partnership with Laing Rail to seek prequalification and bid for a gross cost service contract for the North London Railway Franchise.

## Property business

The Company's property businesses registered significant growth, supported by the strong economy and positive sentiment in the property market.

### Property development

Profit on property developments increased 34.5% to HK\$6,145 million, mainly from Airport Railway developments.

Along the Airport Railway, profit was recognised from surplus proceeds from The Arch, sharing in kind from the second part of Phase 1 of the retail shell at Union Square (Elements), and deferred income in line with construction progress of Harbour Green, the hotel in Tung Chung Package One, Coastal Skyline and Caribbean Coast. On the Tseung Kwan O Line, profit was derived from sharing in kind from The Lane and further proceeds from Residence Oasis and sale of the retail podium at Central Heights.

Along the Airport Railway, developments completed included The Four Seasons Hotel & Four Seasons Place, The Arch, the hotel in Tung Chung Package One, Le Bleu and Carmel Cove, with pre-sales launched for Harbour Green, Carmel Cove, Le Bleu and The Arch, all meeting with strong response.

Along the Tseung Kwan O Line, Central Heights was completed with Occupation Permit obtained in February and pre-sale launched in March. Pre-sales launched for The Grandiose and Phase 1 of Metro Town (Tiu Keng Leng Station) were also successful, with Occupation Permit for The Grandiose obtained in January 2006.

In January, we awarded the tender for Package One of Tseung Kwan O Area 86 to City Investments Limited, a subsidiary of Cheung Kong (Holdings) Limited (Cheung Kong), and Development Agreement was executed in February. The tender for Package Two of Area 86 was launched in December and awarded to Rich Asia Investments Limited, a subsidiary of Cheung Kong in January 2006. We decided in Package One to advance half of the land premium in 2005 with reimbursement upon sale of the development, and in

Package Two to extend HK\$4 billion interest free loan to the developer in 2006, in return respectively for a larger share of development profit and increased sharing in kind.

To better align development to market conditions, a Master Layout Plan reflecting improvements to the Area 86 property development plan was submitted in January 2006. A town planning application to develop a mixed use complex in Tseung Kwan O Town Centre (Area 56) was approved by the Town Planning Board in December.

The Park & Ride project at No. 8 Clear Water Bay Road in Choi Hung was also completed.

### Investment properties

Revenue from investment properties increased by 19.0% to HK\$1,183 million thanks to higher rents, an increased share of rental income from Telford Plaza II and the opening of The Lane in April. Full occupancy at all our shopping centres, including The Lane, was maintained.

International pre-letting of the flagship mall Elements met with a good response, as did pre-letting of The Edge, the new shopping centre at Tseung Kwan O Station.

During the year, we continued our efforts to enhance the retail environment of our shopping centres including the launch of a major renovation programme at Telford Plaza I, and to support our tenants through promotions whilst continuing to add new trades and refine the trade mix.

Hong Kong Disneyland and DRL had a positive impact on Maritime Square, which achieved 30% year-on-year customer growth from September by leveraging off the opening through effective promotions.

Our 18 floors at Two International Finance Centre (IFC) remained fully let.

## Property management and other services

Property management business revenue rose 16.7% to HK\$126 million. During the year, 5,075 units were added from Caribbean Coast, Residence Oasis and Le Bleu, to our management portfolio, bringing the total by year-end to 54,358 residential units and 562,296 square metres of commercial and office space.

Property agency business revenue increased 16.7% to HK\$7 million, while Octopus Access Control business revenue grew 30.0% to HK\$13 million.

## Mainland of China

Our property business experienced further growth in the Mainland of China in the areas of property consultancy, management and related businesses.

Three new property management contracts for high-end residential developments were secured during the year, including Northstar Beiyuan B3 District and Jian Wai Soho Phases Five and Seven in Beijing, and Mei Li Shan Shui in Chongqing.

We signed a head lease of up to 47 years for the operation and property management of Oriental Kenzo, a shopping centre in the Dong Cheng district of Beijing, with plans to re-open in late 2006. The head lease contains an option to buy at a pre-set price within the first five years and a right of first refusal thereafter.

For the property developments for Shenzhen Metro Line 4, the Master Plan is largely finalised.

# Hong Kong network expansion projects

The Tung Chung Cable Car project (branded "Ngong Ping 360") continued to progress with works on the superstructures all substantially completed, together with the cable car towers and the installation of the electrical and mechanical equipment. All cable car cabins were delivered to Hong Kong and all sections of rope pulling were substantially completed by February 2006. Managed by Skyrail-ITM (Hong Kong) Ltd., "Ngong Ping 360" is expected to open mid 2006.

Fit out works for the second platform at the departure level of Airport Station to connect to the Skyplaza retail development are under way, with completion expected in the second half of 2006.

Detailed design has been completed and construction tenders invited for Tseung Kwan O South Station to serve the Area 86 property development by 2009. This will include Government entrustment of the Area 86 Northern Access Road to the Company.

In February, we submitted to the Government revised proposals for the West Island Line, South Island Line (East) and South Island Line (West).

The West Island Line will extend the Island Line from Sheung Wan to Kennedy Town via Sai Ying Pun and University stations. Preliminary design work, geotechnical investigation and environmental impact assessment began and the line is targeted to open in 2012. Discussion has continued with the Government over details including funding issues following Government's decision that planning of the line should proceed.

The South Island Line (East) will run from South Horizons on Ap Lei Chau, via Lei Tung, Wong Chuk Hang and Ocean Park to Admiralty, where it will interchange with the Island Line.

The South Island Line (West) will run from University, where it will interchange with the West Island Line, through Cyberport, Wah Fu and Aberdeen to Wong Chuk Hang, where it will connect with the South Island Line (East). A decision on the South Island Lines is expected in early 2006.

Following the announcement of their possible merger, MTR Corporation and Kowloon-Canton Railway Corporation undertook a revised study of the Shatin to Central Link that included the Kwun Tong Line Extension as an option. In 2005 the Company proposed that it may be prepared to progress this extension in advance of a merger decision. The proposal remains under Government consideration.

Excavation of the main tunnel for the Queensway subway linking Admiralty Station with Three Pacific Place is almost complete and tunnel lining concrete work is in progress. The link is planned to open in the third quarter of 2006. The Government has also authorised a subway connecting the Pioneer Centre to Prince Edward Station, and work is planned for early 2006, with completion by 2008. A scheme to improve access to Lai Chi Kok Station was gazetted and work is expected to begin in 2006.

A proposal was submitted to the Government to extend Causeway Bay Station and a feasibility study began in January 2006. We are also in talks with developers on new links to Tsim Sha Tsui Station.

# Human resources

During 2005, we continued initiatives to raise operational efficiency and invest in human resources.

We completed a study on manpower requirements at the middle to senior management level for our international businesses. This led to initiatives ranging from career posting, flexible deployment of staff, engaging external resources and accelerating local talent development. Of particular importance was the development of a dedicated Resource Pool and Manpower Resource System. We also reviewed employment terms, human resources policies and other support to facilitate staff undertaking overseas assignment.

To enhance the effectiveness of our managers, an individualised and focused approach to leadership development was adopted. The first group of senior and executive managers was assessed and appropriate development methods initiated, including job posting, deputising, executive education and one-on-one coaching.

We offer ample opportunity for staff development and a total of 36,689 man-days of training involving 6,513 employees was conducted during the year. These included customer service courses for DRL and a new Putonghua learning system, "GoChinese".

The Operations Training Department was successfully re-accredited ISO9001, ISO14001 and OHSAS 18001. Our commitment in training was also

recognised with "Platinum ACCA Approved Employer" accreditation from Association of Chartered Certified Accountants (ACCA).

An innovation scheme, the "Enterprising Pod", was launched to foster "Enterprising Spirit". We encourage all staff to generate original ideas to create more revenue / profit for the Company. A senior manager will volunteer as an "Idea Guardian Angel" to ensure the ideas are duly nurtured and to liaise on trial and testing. We have received many submissions from staff at different levels.

In support of Corporate Social Responsibility and Sustainability, we introduced a new employee volunteering scheme "More Time Reaching Community" to strengthen our community involvement. Supported by the Chief Executive Officer and Executive Directorate members, the scheme helps and recognises staff organising and participating in volunteer activities. Response from our caring staff and their family members is encouraging. At the same time, the Community Involvement Team remained active in providing voluntary services.

A Work / Life Balance Study was carried out, with the results indicating a high level of job satisfaction with no impact of work stress on performance or safety. To enhance staff awareness of the concept of "healthy mind, healthy body", seminars on mental and physical health, relationships and work were launched.

# Financial review

## Review of 2005 financial results

On 1 January 2005, the Company adopted changes in accounting policies and financial statement presentation to comply with the revised Hong Kong Financial Reporting Standards (HKFRSs) which include Hong Kong Accounting Standards (HKASs) and Interpretations (HK-Ints) issued by the Hong Kong Institute of Certified Public Accountants. The implications are in the notes to the summary financial statements and comparative figures for 2004 have been restated.

HKAS 40 requires the recognition of the change in market value of investment properties in the profit and loss account (P&L). HKAS 17 requires the land element in leasehold land and building to be accounted for as operating lease, thus re-classifying the previous depreciation for the land element to operating expense. HKASs 32 and 39 require marking derivative instruments to market value. Subject to meeting the requirements to qualify for hedge accounting, those underlying financial liabilities are revalued at their fair values with corresponding adjustments made to their carrying amounts on the balance sheet. The change in value is recognised in the P&L or directly taken to hedging reserve in the balance sheet depending on the type of hedging relationship. Except HKASs 32 and 39 which were adopted prospectively from 1 January 2005, both HKASs 40 and 17 were adopted retrospectively with 2004 comparative figures restated. Following HK-Int 2, certain repair and replacement costs on rails, previously charged to the P&L, are capitalised and depreciated.

These changes affect neither our cashflow nor underlying business performance.

### Profit and loss

Patronage on the MTR Lines increased by 2.9% to a record 858 million. Average fare increased by 2.6% to HK\$6.67 as a result of changes in promotion programmes and the opening of DRL. Fare revenue increased by 5.6% to HK\$5,721 million.

Fare revenue on AEL increased 8.9% to HK\$561 million on increased patronage and higher average fare, the latter supported by more passengers taking longer journeys.

Non-fare revenue grew 18.7% to HK\$2,871 million, comprising HK\$1,555 million from station commercial and other businesses, and HK\$1,316 million from property ownership and management income. Excluding a one-off income from a mobile phone operator for early contract termination, total non-fare revenue would have increased by 15%.

Advertising income rose 9.2% owing to the strong economy and new advertising formats. Income from station commercial facilities increased 15.4% on increased patronage, strong consumer spending and higher rental income. Income from consulting business increased 15.9% as new consulting contracts were secured. Income from miscellaneous activities rose 23.8% owing to connection fees received from new station entrances and increased publications income.

With the opening of a new shopping centre and full-year effect of office and car park rental at Two IFC, together with rental increases after tenancy renewal, income from property ownership and management rose by 18.8%. The favourable factors compensated for relatively stagnant growth in telecommunication income.

Despite the increased scope of activities, operating costs were contained at HK\$4,052 million or 6.0% higher than last year, below the 9.6% revenue growth rate.

The change in the accounting treatment of rails, i.e. capitalised rails repair and replacement costs as fixed assets, led to a reduction in operating cost of HK\$45 million, with a corresponding increase in depreciation of HK\$75

million. The write-back in 2004 of HK\$69 million of revaluation deficit incurred in 2003 in respect of the headquarters building reduced operating costs in 2004. Excluding these two items, operating costs increased by HK\$206 million or 5.4%.

Major drivers of the cost increase included staff costs, which rose by HK\$68 million to cover additional work requirements for new line and station operation, salary growth and special discretionary award. Operational rent & rates increased by HK\$22 million, following growth in operating profit in 2004. Expenses on station commercial and other businesses, as well as property ownership and management business rose by HK\$43 million and HK\$31 million respectively, in line with increased business activity. General and administration expenses increased by HK\$40 million on higher consultancy fees for various studies and safety measures for the WTO Hong Kong Ministerial Conference. HK\$25 million in cost decrease came from our project studies and business development activities in the Mainland of China and Europe.

Operating profit from railway and related operations before depreciation rose 12.6% to HK\$5,101 million. Operating margin improved from 54.2% to 55.7%, the highest in a decade.

Profit on property development in 2005 amounted to HK\$6,145 million, comprising: surplus proceeds from The Arch; recognition of deferred income relating to the hotel part of Tung Chung Packages and Harbour Green at Olympic Station; and sharing in kind from the second part of Phase 1 of Elements and The Lane.

Operating profit before depreciation rose 23.6% to HK\$11,246 million. Depreciation charge increased 7.3% to HK\$2,682 million, mainly owing to the above change in rail capitalisation policy, fully depreciating certain telecommunication equipments upon early contract termination, as well as completion of DRL, the platform screen door project and station renovations.

Despite higher interest rates and interest expense no longer being capitalised to DRL, net interest expense dropped 6.1% to HK\$1,361 million mainly on reduced borrowing. With higher interest rates, average interest cost increased from 4.7% to 5.1%. Interest cover improved to 7.6 times. In compliance with HKAS 40, the increase in market value of investment properties of HK\$2,800 million pre-tax (HK\$2,310 million post tax), was recognised in the P&L.

The Company's share of net profit from OHL rose 2.6% to HK\$40 million. Our bids for franchises in Europe via jointly controlled entities resulted in a HK\$31 million share of net loss. Tax expense, including current tax expense in China and overseas business activities and deferred tax provision, increased 37.1% to HK\$1,549 million. Net profit rose 29.3% to HK\$8,463 million, with HK\$8,450 million attributable to equity shareholders, 29.1% higher. Earnings per share increased from HK\$1.23 to HK\$1.55.

Excluding investment property revaluation and the related deferred tax, underlying profit was HK\$6,140 million or HK\$1.13 per share, respectively 36.7% and 34.5% higher.

The Board recommended a final dividend of HK\$0.28 per share, amounting to HK\$1,535 million, with a scrip dividend option offered to all shareholders except shareholders with registered addresses in the United States of America or any of its territories or possessions. 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 the dividend will be paid in cash.

### Balance sheet

Total fixed assets increased to HK\$103,275 million, mainly attributable to surpluses in investment property revaluation, receipt of The Lane and the capitalisation of DRL and AsiaWorld-Expo Station upon commissioning.



Railway construction in progress increased slightly to HK\$1,006 million, comprising mainly additional capital expenditures on the Tung Chung Cable Car and SkyPlaza Platform projects, partly reduced by the transfer out of DRL and AsiaWorld-Expo Station costs to fixed assets.

Property development in progress increased to HK\$2,756 million, mainly due to the payment of half of the land premium of HK\$1,160 million for Tseung Kwan O Area 86 Package One, partially reduced by cost reimbursement received from developers relating to Olympic Station Package Three, Tiu Keng Leng and Tseung Kwan O Area 86 developments.

Properties held for sale increased to HK\$1,311 million, comprising mainly residential units at The Arch.

In line with the requirement of HKAS 39, derivative financial assets and liabilities of HK\$234 million and HK\$307 million respectively were recorded.

Debtors, deposits and payments in advance increased significantly to HK\$3,095 million, primarily because of increase in receivables relating to pre-sale of properties from The Arch.

Total loans outstanding decreased by HK\$2,114 million to HK\$28,264 million, owing to loan repayments. Loans drawn down amounted to HK\$5,291 million, primarily for refinancing. Deferred income decreased from HK\$4,638 million to HK\$3,584 million following profit recognition at Tung Chung, Kowloon and Olympic station development packages, offset by a payment of HK\$936 million received in respect of Olympic Package Three development.

Deferred tax liabilities increased from HK\$6,368 million to HK\$8,011 million mainly because of the tax effect on profit, including those on property revaluations, at the standard Hong Kong Profits Tax rate of 17.5%.

Share capital, share premium and capital reserve increased by HK\$1,181 million to HK\$37,450 million, as a result of shares issued for scrip dividend and share options exercised. Together with increases in fixed asset revaluation and other reserves of HK\$501 million, opening adjustments on adoption of HKASs 32 and 39 of HK\$124 million and retained earnings net of dividend of HK\$6,177 million, total equity attributable to equity shareholders increased to HK\$69,875 million from HK\$61,892 million. The gross debt-to-equity ratio improved from 49.1% to 40.4% and net debt-to-equity ratio from 48.6% to 39.9%.

### Cash flow

Net cash inflow from railway and related activities increased from HK\$4,486 million to HK\$5,189 million, while cash receipts from property developers and purchasers increased from HK\$2,576 million to HK\$2,610 million. Outflows for capital project payments, including half of the land premium for Tseung Kwan O Area 86 Package One development, and for interest expenses amounted to HK\$3,454 million and HK\$1,416 million respectively, compared to HK\$2,889 million and HK\$1,301 million. With other minor movements, net cash flow before dividends and loan repayments was HK\$2,823 million, HK\$257 million higher. After dividend payments of HK\$1,138 million and net loan repayment of HK\$1,598 million, net cash inflow was HK\$87 million compared to a net outflow of HK\$106 million in 2004.

## Financing activities

### New financings

The Group took advantage of the strong liquidity, low interest rates and tight credit spreads in the Hong Kong dollar market, and raised a total of HK\$4.7 billion new financings at attractive costs during the year. These included a HK\$500 million 10-year note and two HK\$500 million 15-year notes with coupon rates of 4.5%, 4.28% and 4.75% respectively and a total of HK\$3.2 billion bilateral banking facilities comprising HK\$2.2 billion in 7 years and HK\$1.0 billion in 10 years.

At year-end, the Company had total undrawn committed facilities of HK\$5.3 billion, which together with additional bank loan commitments

obtained and proceeds from a new fixed rate note issued in early 2006, would be sufficient to cover all of the Company's funding needs in 2006.

At the subsidiary level, a detailed term sheet was initialled with China Development Bank, which provides for a 25-year RMB3.6 billion non-recourse bank loan and proceeds will be used to fund 60% of the Group's investment in the RMB6.0 billion Shenzhen Metro Line 4 project. Partners of the PPP associated company have also initialled two separate loan agreements with Industrial and Commercial Bank of China and China Development Bank, which provide for two non-recourse 25-year bank loans, each of RMB1.6 billion, for Beijing Metro Line 4. The long maturity, RMB denomination and fixed rate funding provided by these loans will help reduce respectively the refinancing, exchange rate and interest rate risks of the two projects.

### Cost of borrowing

Despite higher short-term interest rates, our average borrowing cost increased only marginally to 5.1% from 4.7% in 2004 with gross interest expense increased by HK\$4 million, reflecting our conservative debt mix which comprised a significant portion in long-term fixed rate financings.

### Risk management

We continued to maintain a well diversified debt portfolio in accordance with our Preferred Financing Model which seeks to diversify risks by specifying a preferred mix of fixed and floating rate debts, maximum currency exposure, well spread out maturities, use of different types of financing instruments and adequate forward coverage of future funding needs.

We use derivative financial instruments solely for hedging purposes and not speculation. We deal only with counterparties with credit ratings of A-/A3 or better, and assign to each counterparty limit based on credit ratings to control counterparty risk exposure. A monitoring framework using "value-at-risk" and "expected loss" concepts is used to quantify and further monitor these exposures.

### Credit ratings

We were the first Hong Kong corporate entity to obtain internationally recognised credit ratings which are on par with the Hong Kong Government.

Moody's re-affirmed our short-term foreign currency and long-term domestic currency ratings at respectively P-1 and Aa3 with stable outlook, and upgraded the long-term foreign currency debt rating for debt issued under foreign laws to Aa3.

S&P affirmed our A-1+ and AA- for short/long-term local currency ratings and concurrently upgraded our short/long-term foreign currency ratings to A-1+ and AA- with a stable outlook.

R&I also re-affirmed our short-term local currency and long-term domestic/foreign currency ratings of respectively a-1+ and AA/AA-.

### Financial planning

We use a comprehensive long-term financial planning model to plan our railway operations and evaluate new investments. The model subjects all investments to rigorous evaluations by taking into account weighted average cost of capital and required rate of return, supplemented by sensitivity analyses on key variables and regular review of assumptions to ensure results are reliable and robust. To manage our cost of capital effectively we also conduct regular assessment of our funding requirement and capital structure.

### Financing capacity

Between 2006 and 2008 inclusive, the Company would have total projected capital expenditures of HK\$5.1 billion for railway projects and HK\$2.1 billion for property developments in Hong Kong, as well as HK\$5.4 billion for overseas investments. Amongst these, funding requirement for the HK\$4.0 billion interest free loan to the developer for Tseung Kwan O Area 86 Package Two in respect of property developments, and the Shenzhen Metro Line 4 in respect of overseas investment has already been secured and as such the Group has sufficient financing capacity to capture other investment opportunities in Hong Kong and overseas.