**THIS CIRCULAR IS IMPORTANT AND REQUIRES YOUR IMMEDIATE ATTENTION**

**This Circular does not constitute, or form part of, an offer or invitation, or solicitation or inducement of an offer, to subscribe for or purchase any of the MTRC Shares or other securities of the Company.**

**If you are in any doubt** as to any aspect of this Circular, or as to the action to be taken, you should consult a licensed securities dealer, bank manager, solicitor, professional accountant or other professional adviser.

**If you have sold or transferred** all your MTRC Shares, you should at once hand this Circular to the purchaser or transferee or to the bank, licensed securities dealer or other agent through whom the sale or transfer was effected for transmission to the purchaser or transferee.



地鐵公司
MTR Corporation

# MTR CORPORATION LIMITED

**（地鐵有限公司）**

**(the "Company")**

(Incorporated in Hong Kong with limited liability)

**(Stock Code: 66)**

# RAIL MERGER
# (1) CONNECTED TRANSACTIONS
# (2) VERY SUBSTANTIAL ACQUISITION

**Joint Financial Advisers to the Company**

Goldman Sachs

**Goldman Sachs (Asia) L.L.C.**

UBS Investment Bank

**UBS Investment Bank**

**Independent Financial Adviser to the Independent Board Committee and the Independent Shareholders**

Merrill Lynch

**Merrill Lynch (Asia Pacific) Limited**

**It is important to note that the purpose of distributing this Circular is to provide the Independent Shareholders of the Company with information, amongst other things, on the proposed Rail Merger, so that they may make an informed decision on voting in respect of the EGM Resolution.**

A letter from the Board is set out on pages 15 to 46 (inclusive) of this Circular.

A letter from the Independent Board Committee, containing its advice to the Independent Shareholders, is set out on pages 47 to 48 (inclusive) of this Circular.

A letter from Merrill Lynch (Asia Pacific) Limited, the Independent Financial Adviser, containing its advice to the Independent Board Committee and to the Independent Shareholders is set out on pages 49 to 84 (inclusive) of this Circular.

A notice convening the Merger EGM to be held on Tuesday, 9 October 2007 at 11:00 a.m. at Rotunda 3 (6/F) Hongkong International Trade & Exhibition Centre, 1 Trademart Drive, Kowloon Bay, Hong Kong is set out on pages N-1 to N-2 of this Circular. A Proxy Form for use in relation to the Merger EGM is also enclosed with this Circular. **Please note that refreshments will not be served at the Merger EGM.**

Whether or not you are able to attend the Merger EGM, you are requested to complete and return the Proxy Form in accordance with the instructions printed thereon, to the Company's registrar, Computershare Hong Kong Investor Services Limited, Rooms 1806-1807, 18th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong, as soon as possible and in any event not later than 48 hours before the time appointed for the Merger EGM or any adjourned meetings thereof. Completion and return of a Proxy Form will not preclude you from attending and voting in person at the Merger EGM or at any adjourned meetings thereof should you so wish.

3 September 2007

| | 2007 |
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| Latest time for lodging transfer forms (accompanied by Share certificates) in order to be entitled to attend and vote at the Merger EGM | 4:30 p.m. on Friday, 5 October |
| Latest time for lodging Proxy Forms for the Merger EGM | 11:00 a.m. on Sunday, 7 October |
| Closure of the register of members of the Company for determination of entitlements to attend and vote at the Merger EGM | 9:00 a.m. on Monday, 8 October until 4:30 p.m. on Tuesday, 9 October |
| Suspension of trading of MTRC Shares | Tuesday, 9 October |
| Merger EGM | 11:00 a.m. on Tuesday, 9 October |
| Announcement of the results of the Merger EGM | on or before Wednesday, 10 October |
| Resumption of trading of MTRC Shares | 9:30 a.m. on Wednesday, 10 October |

**This summary aims to give you an overview of the background to, reasons for and benefits of the Rail Merger and certain other information which is contained in this Circular. Because this is a summary, it does not contain all the information which is important to Shareholders. Shareholders should read the whole document before deciding how to vote with respect to the EGM Resolution.**

## BACKGROUND TO THE RAIL MERGER

In February 2004, the Government invited the Company and KCRC to commence discussions relating to a possible merger of the MTRC Railway and the KCRC Railway. On 11 April 2006, the Company and the Government entered into a Memorandum of Understanding with respect to the Rail Merger. Although it was not binding, the Memorandum of Understanding set out the understanding reached between the Company and the Government regarding the structure and key terms of the Rail Merger. LegCo approved the Rail Merger Ordinance on 8 June 2007, and on 9 August 2007, the Transaction Agreements for the implementation of the Rail Merger were executed (other than those which are required to be executed thereafter). The Transaction Agreements are inter-conditional and, subject to certain conditions, including the Company being required to obtain approval from the Independent Shareholders, will come into effect on the Merger Date.

## REASONS FOR AND BENEFITS OF THE RAIL MERGER

The Rail Merger represents a major milestone in the Company's development as one of the leaders in public transportation in Hong Kong.

The Directors consider the terms of the Rail Merger to be fair and reasonable and in the interests of the Company and the Shareholders as a whole. The Directors recommend the Independent Shareholders to vote in favour of the EGM Resolution for the following reasons:

- **Enhancement of value**

  — As further described on pages 21 to 23 of this Circular, if the Rail Merger had become effective on 1 January 2006, there would have been:

  (i) a 2006 pro-forma underlying earnings per share ("**EPS**") accretion of 13.0% over the Company's 2006 Underlying EPS of HK$1.08. This is before taking into account the estimated impact of (a) the proposed fare reduction, (b) the implementation of the Fare Adjustment Mechanism, (c) the Variable Annual Payment (which is not required to be paid in respect of the first 36 months following the Rail Merger) and (d) estimated full synergies (which are expected to be realised over the first three years after the Merger Date). If all the above were taken into account, the Directors also consider the potential accretion over the 2006 Underlying EPS to be notable;

  (ii) an increase in pro-forma pre-tax profit for 2006 from the Company's rail and related, and property rental and management businesses (excluding property development income and change in fair value of investment properties) of 81.1%. This is before taking into account items (a)-(d) in paragraph (i) above. If all the above were taken into account, the Directors also consider the potential accretion to be very significant; and

  (iii) a net increase of 50.5% in consolidated cashflow from operating activities after including HK$2,719 million of consolidated cashflow from operating activities of KCRC (excluding the payment of the Upfront Payment). This is before taking into account the estimated impact of items (a)-(d) in paragraph (i) above, and the Fixed Annual Payment and capital expenditure to maintain and upgrade the KCRC System. If all the above were taken into account, the Directors also consider the potential accretion to consolidated cashflow from operating activities to be very significant.

  — Based on JLL's professional valuation of the property development rights and investment properties, there would be a pre-tax surplus of HK$2,824 million (HK$2,330 million post-tax) over the consideration payable by the Company in respect of such rights and investment properties at a cost of HK$7,750 million, which represents an increase of 36.4%.

— Improvements in the Company's earnings and cashflow, together with the general financial performance of the Company, will be amongst the factors taken into account by the Board when it considers dividend levels.

- **Benefits to the rail business**

  — The Rail Merger will provide the Company with significant growth through an expanded rail network. The expanded network will increase the Company's franchised public transport market share in Hong Kong from approximately 25% to approximately 40%.

  — The Rail Merger will also bring significant additional future expansion in the form of the Kowloon Southern Link and potentially, possible future railway lines such as the Northern Link and the Express Rail Link, as well as the Shatin to Central Link.

  — Non-fare rail-related revenues would increase by 50.6% from HK$1,542 million to HK$2,322 million (based on an aggregation of the relevant revenues of the Company and KCRC for the year ended 31 December 2006).

  — The Company believes that the Fare Adjustment Mechanism offers a predictable, objective and transparent solution to fare adjustment as it is a direct-drive formula, giving the Company a measure of certainty with respect to its fares.

  — There will be both cost and revenue synergies which are expected to be up to HK$450 million annually once all the proposed synergy programmes are fully implemented (which is expected to be over the first three years after the Merger Date).

- **Benefits to the property business**

  — The Property Package, which forms part of the Rail Merger, comprises the development rights (or the economic benefits thereto), investment properties and a property management business.

  — The Company's development land bank from the acquisition of the development rights (or the economic benefits relating thereto) will increase by 54.3% from 23.2m sq ft to 35.8m sq ft (gross floor area).

  — The gross floor area for investment properties would increase by approximately 22%. Revenue from investment properties and management would increase by 16.0% from HK$1,412 million to HK$1,638 million (based on an aggregation of the relevant revenues of the Company and KCRC for the year ended 31 December 2006).

  — For property development along West Rail, the Company will act as the development agent and receive, in addition to cost reimbursement, a fee of 0.75% of the gross sales proceeds in respect of the unawarded West Rail development sites (comprising approximately 22.7m sq ft gross floor area) and 10% of relevant profits accrued to the West Rail Subsidiaries under the development agreement in respect of the awarded West Rail development site (comprising approximately 1.6m sq ft gross floor area).

- **Benefits of the Rail Merger Transaction structure**

  — The rail component of the Rail Merger has been structured as a service concession, allowing the Company to acquire the rights to access and operate the KCRC System whilst not assuming KCRC's existing debts (except as joint co-obligor with KCRC in relation to the CBLs, in respect of which the Company will receive indemnities from both Government and KCRC) nor paying a significantly greater upfront payment.

  — The Company's gearing ratio on a pro-forma basis would have increased from 30.8% to 57.7% (which includes capitalised Fixed Annual Payments), if the Rail Merger had become effective on 30 June 2007. The Company's interest cover for the year ended 31 December 2006 would have reduced from 6.7x to 4.6x (which includes interest on capitalised Fixed Annual Payments), if the Rail Merger had become effective on 1 January 2006. The Board considers that both the pro-forma gearing ratio and interest cover are acceptable.

— The payment structure under the Rail Merger (i) alleviates the need to finance the transaction with a larger upfront payment, (ii) allows the company to fund a significant portion of the consideration, being the Fixed Annual Payments and the Variable Annual Payments, from internal resources each year and debt and (iii) through the Variable Annual Payments, provides the Company with a certain degree of protection against risks associated with future adverse changes in KCRC System Revenue as the amount of such payments vary with the KCRC System Revenue.

— On 26 July 2007 Moody's upgraded the Company's credit ratings to Aa2 and on 16 July 2007 and 4 July 2007 respectively Standard and Poor's and Rating and Investment Inc. announced that they had affirmed the Company's credit ratings.

## BOARD PROCESS FOR CONSIDERING THE RAIL MERGER

The Board has established and maintained a framework for its decision making processes which, amongst other things, has sought to protect the interests of the Independent Shareholders. The framework has included measures such as (i) Directors who had a conflict of interest not attending the relevant part of Board meetings during which the Rail Merger was discussed, (ii) the Board receiving regular updates on matters relating to the Rail Merger, (iii) the establishment of the Independent Board Committee ("**IBC**"), comprising only independent non-executive Directors, which has taken into account the recommendations of the Independent Financial Adviser, and (iv) the Independent Financial Adviser being selected by the IBC to make recommendations to the IBC and the Independent Shareholders and to advise the Independent Shareholders on how to vote.

## IFA RECOMMENDATION AND ADVICE

The Independent Financial Adviser ("**IFA**"), Merrill Lynch (Asia Pacific) Limited, considers that the terms of the Rail Merger are fair and reasonable and in the interests of the Company and its Shareholders (including Independent Shareholders) as a whole. Accordingly, the IFA advises the Independent Shareholders to vote in favour of the EGM Resolution.

## IBC ADVICE

Having taken into account the recommendations of the IFA, the IBC considers the terms of the Rail Merger and the Transaction Agreements to be fair and reasonable and in the interests of the Company and the Shareholders (including the Independent Shareholders) as a whole and advises the Independent Shareholders to vote in favour of the EGM Resolution.

## NEXT STEPS

Whether or not you are able to attend the Merger EGM, you are requested to complete and return the Proxy Form in accordance with the instructions printed thereon. Doing so will not preclude you from attending the Merger EGM should you so wish.

**Shareholders should read carefully and consider the information contained in this Circular. If you are in any doubt about this Circular, the Merger EGM, the Proxy Form or any action that should be taken, you are advised to consult your licensed securities dealer, bank manager, solicitor, professional accountant or other professional adviser.**

# CONTENTS

*In this Circular the following expressions have the following meanings unless the context requires otherwise:*

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| "**2007 Share Option Scheme**" | means the share option scheme of the Company which was established at the 2007 Annual General Meeting of the Company; |
| "**Additional Concession Property**" | means (i) any asset that is capitalised on the Company's balance sheet and which is acquired, purchased, hired, produced, created, constructed, developed, processed or adapted for use by the Company solely or primarily to maintain, repair, replace or improve any Concession Property; and (ii) any asset that is capitalised on the Company's balance sheet and which is delivered to KCRC prior to the Merger Date but in respect of which, and to the extent that, the Company makes payment therefor after the Merger Date; |
| "**Board**" | means the board of Directors; |
| "**Capex Threshold**" | means HK$115.8 billion (in money of the day terms), as adjusted from time to time pursuant to the Transaction Agreements; |
| "**Category 1 Properties**" | means the Category 1A Properties and the Category 1B Properties; |
| "**Category 1A Properties**" | means (i) 1st Floor, Pierhead Garden Pierhead Plaza, Nos. 168-236 Wu Chui Road, Tuen Mun, New Territories: commercial areas and car parking spaces; (ii) Sun Tuen Mun Centre, Nos. 55-65 Lung Mun Road, Tuen Mun, New Territories: commercial areas, kindergarten and private parking areas; and (iii) Ground Floor and Lower Podium Level, Hanford Garden, No. 333 Castle Peak Road, Tuen Mun, New Territories: commercial areas and car parking spaces; |
| "**Category 1B Properties**" | means (i) Royal Ascot, No. 1 Tsun King Road, Shatin, New Territories: commercial accommodation and kindergarten; and (ii) Royal Ascot, No. 1 Tsun King Road, Shatin, New Territories: residential units and car parking spaces; |
| "**Category 2 Properties**" | means the Category 2A Properties and the Category 2B Property; |
| "**Category 2A Properties**" | means (i) Citylink Plaza, No. 1 Sha Tin Station Circuit, Sha Tin, New Territories: retail floor, 1st to 6th Floors; upper floor of the Link Bridge over Tai Po Road; and certain advertising and telecommunication facilities areas; and (ii) KCRC Hung Hom Building, No. 8 Cheong Wan Road, Hung Hom, Kowloon: portions of Ground Floor and 1st Floor; and certain telecommunication facilities areas; |
| "**Category 2B Property**" | means Trackside Villas, No. 4105 Tai Po Road, Tai Po, New Territories: staff quarters and club house; |
| "**Category 3 Properties**" | means (i) Ho Tung Lau (Site A), East Rail, Sha Tin Town Lot No. 470, New Territories; (ii) Wu Kai Sha, Ma On Shan Rail, Sha Tin Town Lot No. 530, New Territories; and (iii) Tai Wai Maintenance Centre, Ma On Shan Rail, Sha Tin, Sha Tin Town Lot No. 529, New Territories; |

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| "**Category 4 Properties**" | means the development sites at (i) Che Kung Temple, Ma On Shan Rail, Sha Tin, New Territories; (ii) Tai Wai Station, Ma On Shan Rail, Sha Tin, New Territories; (iii) Tin Shui Wai Terminus, Light Rail, Yuen Long, New Territories; (iv) Kowloon Southern Link — Site C, Tsimshatsui, Kowloon; and (v) Kowloon Southern Link — Site D, Tsimshatsui, Kowloon; |
| "**CBLs**" | means the US cross border leases entered into between KCRC and certain counterparties as specified in the Merger Framework Agreement; |
| "**Circular**" | means this circular; |
| "**Commissioner**" | means the Commissioner for Transport; |
| "**Company's Share Options**" | means the share options issued by the Company pursuant to its Pre-Global Offering Share Option Scheme, New Joiners Share Option Scheme and 2007 Share Option Scheme; |
| "**Concession Fares**" | means fares in respect of journeys on the KCRC Railway and/or the MTRC Railway for (i) children aged three or above but below the age of 12 provided that a child is deemed to be aged three or above if his/her height is 95 centimetres or above; and (ii) the elderly (being persons aged 65 and above); |
| "**Concession IP**" | means the Intellectual Property Rights owned by KCRC and set out in the Service Concession Agreement; |
| "**Concession Payments**" | means the Upfront Payment, the Fixed Annual Payments and the Variable Annual Payments and in respect of any New Project Concession Property, any payment specified in the relevant Supplemental Service Concession Agreement to be a "Concession Payment" for the purposes of the Service Concession Agreement; |
| "**Concession Period**" | means an initial period of 50 years from the Merger Date, as may be extended pursuant to the Service Concession Agreement. The Concession Period will end if the Franchise relating to the KCRC Railway is revoked; |
| "**Concession Property**" | means (i) the Concession Property as at the Merger Date, as described in the Service Concession Agreement; (ii) any Additional Concession Property; and (iii) with respect to a New Project, the property designated in the relevant Supplemental Service Concession Agreement to be "New Project Concession Property with respect to such New Project for the purposes of the Service Concession Agreement", and for the avoidance of doubt, it does not include the Excluded Assets, the Purchased Rail Assets or the Category 1 Properties and Category 2 Properties or any intellectual property rights other than Concession IP; |
| "**Conditions**" | means the conditions to completion of the Rail Merger, which are provided in the Merger Framework Agreement (further details of the Conditions are contained in the paragraph headed "Conditions Precedent to the Rail Merger" in the section of this Circular headed "Letter from the Board"); |

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| "**Directors**" | means the directors of the Company; |
| "**Domestic Services**" | means the services for the carriage of passengers currently provided by the Company, within Hong Kong, on the railway; |
| "**EGM Resolution**" | means the resolution to be voted on by the Independent Shareholders at the Merger EGM, which is contained in the "Notice of Extraordinary General Meeting" set out on pages N-1 to N-2 (inclusive) of this Circular; |
| "**Enlarged Group**" | means the Group as enlarged as a result of the Rail Merger; |
| "**ER**" or "**East Rail**" | means the railway line connecting Lo Wu and Lok Ma Chau to East Tsim Sha Tsui (or, upon commencement of operations on the KSL, Hung Hom) starting from and ending in Hong Kong, used for the conveyance of passengers within Hong Kong and, for the avoidance of doubt, does not include any of the intercity passenger services and freight services on such railway line; |
| "**ERE**" or "**East Rail Extensions**" | means the railway extension connecting East Tsim Sha Tsui and Hung Hom and known as East Rail Tsim Sha Tsui Extension; |
| "**Excluded Assets**" | means (i) all contracts to which KCRC is a party or the benefit of which is held in trust for or has been assigned to it, other than those contracts specified to be vested (by statute) in, novated or assigned to, the Company; (ii) certain shares held in certain KCRC subsidiaries and other shares held by KCRC; (iii) certain receivables (but excluding receivables due under contracts to be vested in the Company in accordance with the MTR Ordinance); (iv) cash in hand or at the bank, certificates of deposit, commercial paper and all other financial investments and other cash equivalents, each as at the Merger Date (less amounts relating to security deposits, retention monies and advances held by KCRC in relation to the Purchased Rail Assets); (v) KCRC's rights to set off tax liabilities against its tax losses and all rights of KCRC to, and utilise in any way, all of its tax losses; (vi) the project agreement between KCRC and the Government in respect of the KSL and any related agreements; (vii) the Transaction Agreements; (viii) the KCRC Financing Documents and the loan agreement entered into between KCRC and West Rail Property Development Limited in respect of West Rail property developments; (ix) certain intellectual property owned by KCRC; (x) all insurance arrangements to which KCRC is a party; (xi) amounts recoverable in respect of taxation relating to the Purchased Rail Assets attributable to periods ended on or before, or transactions occurring on or before, the Merger Date; (xii) all cash deposits made by KCRC or any of its subsidiaries in connection with the CBLs; (xiii) floors seven to ten (inclusive) of Citylink Plaza; (xiv) all expenditure incurred on or in relation to SCL and/or the Northern Link/Express Rail Link; (xv) all files and administrative records relating solely to the Excluded Assets; (xvi) all board minutes and board papers of KCRC; and (xvii) certain club memberships of KCRC; |
| "**Existing Operating Agreement**" | means the operating agreement entered into on 30 June 2000 between the then Secretary for Transport (on behalf of the Government) and the Company, as amended from time to time; |

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| "**Fare Adjustment Mechanism**" or "**FAM**" | means the adjustment mechanism to be applied to certain of the Company's fares after the Rail Merger as set out in the Operating Agreement (further details of the FAM are contained in the paragraph headed "Background of the Rail Merger" in the section of this Circular headed "Letter from the Board"); |
| "**Financial Secretary Incorporated**" or "**FSI**" | means a corporation sole established under the Financial Secretary Incorporation Ordinance (Cap. 1015 of the Laws of Hong Kong); |
| "**Fixed Annual Payment**" | means a fixed annual payment to be made by the Company to KCRC in accordance with the SCA, being HK$750 million per annum (further details of the Fixed Annual Payment are contained in the paragraph headed "The Rail Merger Package and Consideration" in the section of this Circular headed "Letter from the Board"); |
| "**Franchise**" | has the meaning given to "franchise" in the MTR Ordinance; |
| "**Frontline Staff**" | means those full-time non-managerial staff of KCRC and the Company (as the case may be) who are employed regularly and directly in the operations and maintenance of trains, stations, buses and vehicles; infrastructure maintenance; stores operations and security operations. Non-managerial staff refers to staff below Grade MG1 in the case of the Company and staff below Grade 8 in the case of KCRC, who are employed on either continuous terms or on contract terms for a duration of two years or more; |
| "**Government**" | means the Government of Hong Kong and, where the context so requires, the Financial Secretary Incorporated; |
| "**Group**" | means the Company and each of its subsidiaries; |
| "**Group's Bonds**" | means the bonds issued by the members of the Group comprising US dollar Global notes due 2009; US dollar Global notes due 2010; Debt issuance programme Eurobond due 2014; Debt issuance programme notes due between 2008 to 2020; and HK dollar notes due 2008; |
| "**Hong Kong**" | means the Hong Kong Special Administrative Region of the PRC; |
| "**Incremental Revenues**" | means the net fare revenues expected to be generated by the Company from the operation of the Integrated Railway (and the New Railway) and resulting from its operation of the New Railway and certain other net railway related revenues expected to be generated by the Company from its operation of the New Railway; |
| "**Independent Board Committee**" | means a committee of independent non-executive Directors comprising Edward Ho Sing-tin (*Chairman*), Professor Cheung Yau-kai, David Gordon Eldon, Christine Fang Meng-sang, Lo Chung-hing and T. Brian Stevenson, appointed in accordance with Listing Rule 13.39(6)(a); |
| "**Independent Financial Adviser**" or "**Merrill Lynch**" | means Merrill Lynch (Asia Pacific) Limited, being an independent financial adviser, appointed in accordance with Rule 13.39(6)(b) of the Listing Rules; |

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| "**Independent Shareholders**" | means all Shareholders other than the Government and its associates; |
| "**Initial Payments**" | means the Upfront Payment and the Upfront Property Payment; |
| "**Integrated Railway**" | means the MTRC Railway and the KCRC Railway; |
| "**Integrated System**" | means the MTRC Railway and the KCRC System from time to time; |
| "**Intellectual Property Rights**" | means patents, designs, copyrights, topographies, trade marks, service marks, trading names, domain names, rights in confidential information and know-how, any other intellectual property and any associated or similar rights to any of the foregoing (in each case whether registered or unregistered and including applications and rights to apply for the same and wherever and whenever subsisting); |
| "**Job Security Deed Poll**" | means the deed poll to be executed by the Company on the Merger Date relating to the job security of Relevant Frontline Staff; |
| "**Jones Lang LaSalle**" or "**JLL**" | means Jones Lang LaSalle Limited, the independent property valuer appointed for the purpose of preparing the Property Valuation Report contained in the Appendix to this Circular headed "Property Valuation Report on the Enlarged Group"; |
| "**KCRC**" | means the Kowloon-Canton Railway Corporation a statutory corporation established under the KCRC Ordinance wholly owned by the Financial Secretary Incorporated on behalf of the Government in accordance with the KCRC Ordinance; |
| "**KCRC Bondholders**" | means the holders of KCRC's HK dollar retail notes due 2008 and 2013; US dollar Global notes due 2010; Debt issuance programme US dollar notes due 2009 and 2014; and Debt issuance programme HK dollar notes due 2013; |
| "**KCRC Claims**" | means all Non-Project Claims made by third parties who are not related to the Company if the relevant cause of action arose before the Merger Date and the relevant claim is brought within the first three years following the Merger Date; |
| "**KCRC Financing Documents**" | means the agreements, documents or other instruments relating to financing arrangements to which KCRC is or becomes party (including, without limitation, loans, bonds, notes, finance or cross border leases, bank facilities, export credit agency facilities and swaps and derivative instruments and those financing arrangements described in the Merger Framework Agreement); |
| "**KCRC Ordinance**" | means the Kowloon-Canton Railway Corporation Ordinance (Cap. 372 of the Laws of Hong Kong), as amended from time to time (and where the context requires, as amended by the Rail Merger Ordinance); |
| "**KCRC Property Subsidiaries**" | means (i) Hanford Garden Property Management Company Limited; (ii) Pierhead Garden Management Company Limited; and (iii) Sun Tuen Mun Centre Management Company Limited; |

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| "**KCRC Railway**" | means the railway system consisting of: (i) the "Kowloon-Canton Railway" as defined in the KCRC Ordinance (composed of the East Rail); (ii) the Light Rail; (iii) the intercity passenger and freight rail system; (iv) the ERE; (v) the MOSR; (vi) the West Rail; (vii) LMCSL; (viii) KSL on the date of its completion; and (ix) any other railway system which is designated as a "KCRC Railway" in any Supplemental Service Concession Agreement; |
| "**KCRC Railway Land**" | means (excluding any KCRC Railway Land which falls within the definition of Excluded Assets): (i) all land and interests or other rights in respect of land which from time to time is granted or vested to KCRC and comprised within the definition of "railway premises" in section 2(1) of the KCRC Ordinance, but with all references to the term "railways" in such definition being treated as a reference to: (a) those "railways" (as defined in Section 2(1) of the KCRC Ordinance) operated by KCRC immediately prior to the Merger Date; and (b) KSL; (ii) with respect to any New Project, any land and interests or other rights in respect of land designated in the relevant Supplemental Service Concession Agreement as part of the KCRC Railway Land; and (iii) any other land and interests or other rights in respect of land which the parties may agree or as the Government may direct from time to time is to be comprised in the definition of KCRC Railway Land; |
| "**KCRC Related Businesses**" | means, at any particular time, the businesses related to the KCRC Railway and the TSA Buses which may include, without limitation, advertising, telecommunications, duty free, kiosk rental, station trading, car park rental, machine and terminal rental businesses (but excluding, for the avoidance of doubt, the property development, property investment and property management rights that are part of the Property Package); |
| "**KCRC Services**" | means the services to be provided by the Company pursuant to the SCA through the operation of the KCRC System pursuant to the SCA and/or, as the case may be, the relevant Supplemental Service Concession Agreement, and certain of which services are regulated through the Operating Agreement; |
| "**KCRC Subsidiaries**" | means (i) Hanford Garden Property Management Company Limited; (ii) Pierhead Garden Management Company Limited; (iii) Royal Ascot Management Company Limited; (iv) Sun Tuen Mun Centre Management Company Limited; and (v) V-Connect Limited; |
| "**KCRC System**" | means the KCRC Railway, the TSA Buses and the KCRC Related Businesses, from time to time; |
| "**KCRC System Revenue**" | means, with respect to each financial year of the Company (or any part thereof), the amount determined in accordance with the SCA; |
| "**km**" | means kilometres; |

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| "**KPMG**" | means KPMG, the reporting accountant appointed for the purpose of preparing the Accountants' Report on the KCRC Group, on the basis as set out in the Appendix to this Circular headed "Accountants' Report on KCRC"; and for the purpose of preparing a report in respect of the unaudited pro-forma financial information of the Enlarged Group on the basis as set out in the Appendix to this Circular headed "Financial Information of the Enlarged Group"; |
| "**KSL**" or "**Kowloon Southern Link**" | means the railway line connecting Nam Cheong and Hung Hom, known as the Kowloon Southern Link; |
| "**KSL Project Management Agreement**" | means the agreement so entitled relating to KSL entered into on the Signing Date between the Company and KCRC (further details of the KSL Project Management Agreement are contained in the paragraph headed "KSL Project Management Agreement" in the Appendix to this Circular headed "Transaction Agreements"); |
| "**Land Comfort Letter**" | means the letter dated 3 August 2007 from Government to KCRC (further details of the Land Comfort Letter are contained in the paragraph headed "Land Comfort Letter" in the Appendix to this Circular headed "Transaction Agreements"); |
| "**Latest Practicable Date**" | means 22 August 2007, being the latest practicable date prior to the printing of this Circular for ascertaining information contained herein; |
| "**LegCo**" | means the Legislative Council of Hong Kong; |
| "**Liaison Committee Letter**" | means the letter so entitled dated the Signing Date from KCRC in favour of the Company and the Government; |
| "**Light Rail**" or "**LR**" | means the light rail system serving Tuen Mun New Town and Yuen Long, also known as the "North-west Railway" (as defined in the KCRC Ordinance) but disregarding any extension thereof on or after the Merger Date; |
| "**Listing Rules**" | means the Rules Governing the Listing of Securities on The Stock Exchange; |
| "**LMCSL**" or "**LMC Spur Line**" | means the railway connecting Lok Ma Chau and Sheung Shui known as the Lok Ma Chau Spur Line; |
| "**Mainland**" | means the mainland of the PRC; |
| "**Memorandum of Understanding**" or "**MOU**" | means the confidential memorandum of understanding entered into on 11 April 2006 between the Company and the Government in relation to the Rail Merger; |
| "**Memorandum on Performance Requirements**" | means the memorandum so entitled entered into on the Signing Date between the Company and the Government which sets out the prescribed formulae for calculating the performance requirements of the Integrated Railway and the provision of the Integrated System referred to in the Operating Agreement; |

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| "**Merger Date**" or "**Appointed Day**" | means the day appointed by the Secretary pursuant to the Rail Merger Ordinance on which the Rail Merger Ordinance comes into operation; |
| "**Merger EGM**" | means the extraordinary general meeting of the Company to be held to seek approval of Independent Shareholders for the Rail Merger the notice in relation to which is set out on pages N-1 to N-2 (inclusive) of this Circular; |
| "**Merger Framework Agreement**" or "**MFA**" | means the agreement so entitled entered into on the Signing Date between the Company, KCRC and the Government (further details of the MFA are contained in the paragraph headed "Merger Framework Agreement" in the Appendix to this Circular headed "Transaction Agreements"); |
| "**Metropolis**" | means The Metropolis Management Company Limited; |
| "**Metropolis Equity Sub-participation Agreement**" | means the agreement so entitled, entered into on the Signing Date between the Company and KCRC (further details of the Metropolis Equity Sub-participation Agreement are contained in the paragraph headed "Metropolis Equity Sub-participation Agreement" in the Appendix to this Circular headed "Transaction Agreements"); |
| "**MOSR**" or "**MOS Rail**" | means the railway line connecting Wu Kai Sha and Tai Wai; |
| "**MTR Club**" | means the passenger loyalty benefits club established by the Company; |
| "**MTR Ordinance**" | means the Mass Transit Railway Ordinance (Cap. 556 of the Laws of Hong Kong), as amended from time to time (and where the context requires, as amended by the Rail Merger Ordinance); |
| "**MTRC**" or "**the Company**" | means MTR Corporation Limited, a company incorporated in Hong Kong under the Companies Ordinance (Cap. 32 of the Laws of Hong Kong) with company number 714016, whose registered office is at MTR Tower, Telford Plaza, Kowloon Bay, Hong Kong; |
| "**MTRC Claims**" | means all claims made on or after the Merger Date that are not KCRC Claims or Railway Project Claims, other than claims relating to any of the Excluded Assets; |
| "**MTRC Railway**" | means the "Mass Transit Railway" as defined in the MTR Ordinance, which, for the avoidance of doubt, excludes the KCRC Railways, as such term is defined in the MTR Ordinance; |
| "**MTRC Services**" | means the services provided from time to time through the operation of the MTRC Railway; |
| "**MTRC Shares**" or "**Shares**" | means the ordinary shares of HK$1.00 each in the capital of the Company; |
| "**Natural Expiry Date**" | means the date which falls on the day immediately preceding the 50th anniversary of the Merger Date; |

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| "**Net Cash Flow of the New Project**" | means, the Incremental Revenues minus (i) the incremental operating costs and incremental on-going capital expenditure which are expected to be borne by the Company from the operation of the Integrated Railway (and the relevant New Railway) and resulting from its operation of a relevant New Railway; and (ii) the expected incremental tax charge which will need to be borne by the Company as operator of the relevant New Railway and which is attributable to the relevant New Railway; |
| "**New Joiners Share Option Scheme**" | means the share option scheme of the Company which was established at the Company's 2002 Annual General Meeting to provide share options to new members of the top and senior management of the Company who did not participate in the Pre-Global Offering Share Option Scheme; |
| "**New KCR Project**" | means any new railway project the scope of which includes the construction, operation and/or maintenance of (i) one or more new stations; and (ii) new track work which extends an existing line which forms part of any KCRC Railway, or deviates from an existing line which forms part of any KCRC Railway, other than a new railway project the scope of which also includes the construction and/or operation of a transport interchange between a part of that railway project and a railway system other than any KCRC Railway; |
| "**New MTR Project**" | means any new railway project the scope of which includes the construction, operation and/or maintenance of (i) one or more new stations and (ii) new track work which extends an existing line which forms part of the MTRC Railway, or deviates from an existing line which forms part of the MTRC Railway, other than a new railway project the scope of which also includes the construction and/or operation of a transport interchange between a part of that railway project and a railway system other than the MTRC Railway; |
| "**New Project**" | means any New MTR Project, New KCR Project or any New Separate Project; |
| "**New Project Concession Property**" | means with respect to any New Project, means the property designated in the relevant Supplemental Service Concession Agreement to be "New Project Concession Property" with respect to such New Project for the purposes of the SCA; |
| "**New Railway**" | means the railway (or, where the context so requires, such portion thereof) to be constructed, modified, improved and/or extended (as the case may be) pursuant to a New Project; |
| "**New Separate Project**" | means any new railway project which is neither a New MTR Project nor a New KCR Project; |
| "**Non-managerial Staff**" | means those staff below Grade MG1 in the case of the Company and staff below Grade 8 in the case of KCRC, who are employed on either continuous terms or on contract terms for a duration of two years or more; |
| "**Non-Project Claims**" | means claims made against KCRC or the subsidiaries of KCRC that are not Railway Project Claims; |

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| "**OA**" or "**Operating Agreement**" | means the agreement so entitled entered into on the Signing Date between the Company and the Government which, from and including the Merger Date, will be the Operating Agreement for the purposes of the MTR Ordinance (further details of the OA are contained in the paragraph headed "Operating Agreement" in the Appendix to this Circular headed "Transaction Agreements"); |
| "**Octopus**" | means the contactless smart card ticketing system in Hong Kong known as "Octopus" (or any replacement for such system); |
| "**Outsourcing Agreement**" | means the outsourcing agreement entered into on the Signing Date between the Company and KCRC (further details of the Outsourcing Agreement are contained in the paragraph headed "Outsourcing Agreement" in the Appendix to this Circular headed "Transaction Agreements"); |
| "**PRC**" | means the People's Republic of China; |
| "**Pre-Global Offering Share Option Scheme**" | means the share option scheme of the Company which was established in September 2000 (in connection with the initial public offering and Stock Exchange listing of the MTRC Shares) and pursuant to which certain employees of the Company were granted options to purchase MTRC Shares; |
| "**Property Enabling Works Development Sites**" | means development sites at Ho Tung Lau, Wu Kai Sha, Tai Wai Maintenance Centre, Che Kung Temple, Tai Wai Station, Tin Shui Wai LR, KSL Site C and KSL Site D; |
| "**Property Package**" | means the package of property-related rights (including agency and management rights) conferred on the Company pursuant to the Property Package Agreements and the SPA; |
| "**Property Package Agreements**" | means each of the agreements or documents relating to the Category 1 Properties, the Category 2 Properties, the Category 3 Properties, the Category 4 Properties and the Metropolis Equity Sub-Participation Agreement (further details of the Property Package Agreements are contained in the paragraph headed "Property Package Agreements" in the Appendix to this Circular headed "Transaction Agreements"); |
| "**Proxy Form**" | means the form of proxy issued by the Company for the purposes of the Merger EGM and any adjournments thereof; |
| "**Purchased Rail Assets**" | means all the property and assets of KCRC, shares in the KCRC Subsidiaries (which subsidiaries shall hold, amongst other things, the Category 1A Properties and act as property managers), and all those contracts of KCRC which are to be vested (by statute), novated and assigned to the Company with effect from the Merger Date (including, business plant and machinery, tools and equipment, stock, stores and spares, intellectual property and business information and records) but excluding the Category 1 Properties, the Category 2 Properties, the Category 3 Properties, the Excluded Assets, the Concession Property and the West Rail Agency Agreement; |

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| "**Rail Merger**" | means the proposed merger of the operations of the Company and KCRC and the other transactions documented in, or contemplated by, the Transaction Documents; |
| "**Rail Merger Ordinance**" | means the Rail Merger Ordinance (Ordinance No. 11 of 2007); |
| "**Railway Project**" | means any of West Rail, ERE, MOSR, the upgrade works to the Light Rail signalling system to be carried out under Contract Number DB2040, disregarding any extension thereof on or after the Merger Date; or KSL or LMCSL; |
| "**Railway Project Claims**" | means all claims against KCRC or the subsidiaries of KCRC made by third parties who are not related to the Company in relation to any works undertaken or services provided in respect of the design, manufacturing, construction, testing or commissioning of any Railway Project (including, without limitation, claims in relation to land resumption and business interruption) (i) prior to the opening of that Railway Project for use by the public; or (ii) that should, pursuant to the initial construction programme relating to that Railway Project, have been undertaken prior to the opening of that Railway Project for use by the public; or (iii) during the defects liability period relating to such works or services referred to in (i) and/or (ii); |
| "**Relevant Frontline Staff**" | means (i) KCRC staff who, pursuant to the Rail Merger Ordinance, become employees of the Company on the Merger Date; and (ii) staff of the Company who remain employees of the Company on the Merger Date, and who, in each case (a) were in employment as Frontline Staff on 11 April 2006, or become employed as Frontline Staff at any time between 11 April 2006 up to and including the Merger Date, even if subsequently transferred to a non-Frontline Staff role at the instigation of (1) KCRC (but only prior to the Merger Date) or (2) the Company (at any time). For the avoidance of doubt, Relevant Frontline Staff excludes those staff members of KCRC or the Company who cease to be Frontline Staff out of their own actions or initiative; |
| "**Required Standards**" | means in relation to the MTRC Railway and/or the KCRC Railway and/or the TSA Buses (as the case may be), the safety, performance and other operational standards prescribed in the MTR Ordinance (including, without limitation, in relation to the TSA Buses in section 9(2) of the MTR Ordinance) and the Operating Agreement for the Integrated System from time to time (and any other instruments, agreements or other documents as agreed by Government and the Company from time to time) (but, for the avoidance of doubt, excludes the Customer Service Pledges as defined in the Operating Agreement); |
| "**SCA**" or "**Service Concession Agreement**" | means the agreement so entitled entered into on the Signing Date between the Company and KCRC (further details of the SCA are contained in the paragraph headed "Service Concession Agreement" in the Appendix to this Circular headed "Transaction Agreements"); |

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| "**SCL**" or "**Shatin to Central Link**" | means the proposed rail link between Shatin and Central, Hong Kong consisting of (i) an extension of the existing MOSR from Tai Wai to Hung Hom; and (ii) an extension of its existing ER from Hung Hom to Central, Hong Kong; |
| "**Secretary**" | means the Secretary for Transport and Housing; |
| "**Service Concession**" | means the service concession and licence granted by KCRC to the Company under the Service Concession Agreement; |
| "**SFO**" | means Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong); |
| "**Shareholders**" | means all registered holders of MTRC Shares; |
| "**Signing Date**" | means 9 August 2007; |
| "**SPA**" or "**Sale and Purchase Agreement**" | means the agreement so entitled entered into on the Signing Date between the Company and KCRC (further details of the SPA are contained in the paragraph headed "Sale and Purchase Agreement" in the Appendix to this Circular headed "Transaction Agreements"); |
| "**Stock Exchange**" | means The Stock Exchange of Hong Kong Limited; |
| "**Student Fares**" | means fares in respect of journeys on the KCRC Railway and/or the MTRC Railway payable by persons who are aged from 12 to 25 enrolled on a full-time course in a school approved by the Company, and such person carries with him/her at the time of travel on the KCRC Railway and/or the MTRC Railway a personalised Octopus card with such person's student status encoded on it; |
| "**Supplemental Service Concession Agreement**" | means a supplemental service concession agreement in respect of any New Project entered into between the Company and KCRC pursuant to Service Concession Agreement; |
| "**sq ft**" | means square feet; |
| "**sq m**" | means square metres; |
| "**Transaction Agreements**" | means the Merger Framework Agreement, the Service Concession Agreement, the Sale and Purchase Agreement, the Operating Agreement, the Supplemental Service Concession Agreements (if any), the Job Security Deed Poll; the KSL Project Management Agreement, the West Rail Agency Agreement, the Property Package Agreements, the US CBL Assumption Agreements, the US CBL Allocation Agreement, the Outsourcing Agreement, the Liaison Committee Letter, the Land Comfort Letter, and any other document designated in writing as a "Transaction Agreement" by Government, MTRC and KCRC, each (to the extent not defined elsewhere in this Circular) as defined in the Merger Framework Agreement; |
| "**Transaction Documents**" | means the Transaction Agreements and the Rail Merger Ordinance; |
| "**TSA Buses**" | means the "TSA bus service" as defined in the MTR Ordinance; |

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| "**Upfront Payment**" | means the payment to be made by the Company to KCRC on the Merger Date in an amount totalling HK$4.25 billion, being the agreed fee for the right to operate the Service Concession and the consideration for the Purchased Rail Assets; |
| "**Upfront Property Payment**" | means the payment to be made by the Company to KCRC on the Merger Date in an amount totalling HK$7.79 billion in consideration for the execution of the Property Package Agreements, pursuant to the Merger Framework Agreement and the sale of the shares in the KCRC Subsidiaries under the Sale and Purchase Agreement; |
| "**US CBL Allocation Agreement**" | means the agreement so entitled expected to be entered into on or before the date that the Company enters into a US CBL Assumption Agreement between, amongst others, the Company and KCRC (further details of the US CBL Allocation Agreement are contained in the paragraph headed "US CBL Allocation Agreement" in the Appendix to this Circular headed "Transaction Agreements"); |
| "**US CBL Assumption Agreements**" | means the agreements so entitled expected to be entered into on or prior to the Merger Date between, amongst others, the Company and KCRC (further details of the US CBL Assumption Agreements are contained in the paragraph "US CBL Assumption Agreements" in the Appendix to this Circular headed "Transaction Agreements"); |
| "**US$**" | means United States dollars; |
| "**Variable Annual Payment**" | means a variable annual payment to be made by the Company to KCRC in accordance with the SCA (further details of the Variable Annual Payment are contained in the paragraph headed "The Rail Merger Package and Consideration" in the section of this Circular headed "Letter from the Board"); |
| "**West Rail Agency Agreement**" | means the agreement so entitled entered into on the Signing Date between the Company, KCRC and certain of KCRC's subsidiaries, (further details of the West Rail Agency Agreement are contained in the paragraph headed "West Rail Agency Agreement" in the Appendix to this Circular headed "Transaction Agreements"); |
| "**West Rail Subsidiaries**" | has the meaning given to it in the paragraph headed "West Rail Agency Agreement" in the paragraph headed "Transaction Agreements" in the section of this Circular headed "Letter from the Board"; |
| "**WR**" or "**West Rail**" | means the railway line connecting Tuen Mun and Nam Cheong; and |
| "**WRPDL Minimum Retained Amount**" | has the meaning given to it in the paragraph headed "West Rail Agency Agreement" in the Appendix to this Circular headed "Transaction Agreements". |

This Circular contains forward-looking statements. The words "believe", "intend", "is confident", "expect", "anticipate", "project", "estimate", "predict" and similar expressions identify forward-looking statements. These forward-looking statements are not facts. Rather, the forward-looking statements are based on the current beliefs, intentions, assumptions, expectations, anticipations, projections, estimates and predictions of the Directors and management of the Company (or, as the case may be, and other person or persons to which they apply).

These forward-looking statements may include statements relating to revenues and earnings. Directors of the Company believe that the expectations, estimates and projections reflected in these forward-looking statements are reasonable. However, these statements are not guarantees of future performance and are subject to risks, uncertainties and other factors, some of which are beyond the control of the Company and are difficult to predict. Consequently, actual results could differ materially from the information contained in any such forward-looking statements.

Special attention is drawn to the risk factors contained in the Appendix to this Circular headed "Risk Factors" but generally, undue reliance should not be placed on forward-looking statements, which reflect the views of the relevant person or persons as at the Latest Practicable Date only. Subject to any requirements of the Listing Rules and the SFO, the Company undertakes no obligation to publicly revise these forward-looking statements to reflect events or circumstances that arise after the Latest Practicable Date.

地鐵公司
MTR Corporation

# MTR CORPORATION LIMITED
**（地鐵有限公司）**

(Incorporated in Hong Kong with limited liability)

**(Stock Code: 66)**

**The Board**
*Non-Executive Directors*
Dr. Raymond Ch'ien Kuo-fung *(Chairman)*
Professor Chan Ka-keung, Ceajer (Secretary for Financial Services and the Treasury)
Secretary for Transport and Housing (Eva Cheng)
Commissioner for Transport (Alan Wong Chi-kong)

*Independent Non-Executive Directors*
Professor Cheung Yau-kai
David Gordon Eldon
Christine Fang Meng-sang
Edward Ho Sing-tin
Lo Chung-hing
T. Brian Stevenson

*Executive Director*
Chow Chung-kong *(Chief Executive Officer)*

**The Executive Directorate**
Chow Chung-kong *(Chief Executive Officer)*
Russell John Black
William Chan Fu-keung
Thomas Ho Hang-kwong
Lincoln Leong Kwok-kuen
Francois Lung Ka-kui
Andrew McCusker
Leonard Bryan Turk

*Registered Office:*
MTR Tower
Telford Plaza
Kowloon Bay
Hong Kong

*Principal Office:*
MTR Tower
Telford Plaza
Kowloon Bay
Hong Kong

3 September 2007

To the Shareholders and, for information only, holders of the Group's Bonds and holders of the Company's Share Options

Dear Sir or Madam,

## RAIL MERGER
## (1) CONNECTED TRANSACTIONS
## (2) VERY SUBSTANTIAL ACQUISITION

### 1. INTRODUCTION

As stated in the announcement dated 9 August 2007 made by the Company in relation to the Rail Merger and as a result of negotiations between the Company, the Government and KCRC, certain Transaction Agreements for the implementation of the Rail Merger were entered into on 9 August 2007. The implementation of the Rail Merger is subject to, amongst other things, Independent Shareholders' approval and the commencement of the Rail Merger Ordinance. The principal terms of the Transaction Agreements are summarised in the paragraph headed "Summary of Transaction Agreements" in this section of this Circular and further details of the Transaction Agreements are set out in the Appendix to this Circular headed "Transaction Agreements".

The purpose of this Circular is primarily to give you, as a Shareholder, information regarding the Rail Merger so that you can make an informed decision on how to vote with respect to the EGM Resolution. The Merger EGM will be held on 9 October 2007 to consider and if thought fit approve the EGM Resolution. Formal notice of the Merger EGM and details of the EGM Resolution are contained on pages N-1 to N-2 of this Circular.

The Rail Merger involves the following key elements:

(1) the expansion of the Company's existing franchise under the MTR Ordinance to provide the Company with the right to operate the KCRC Railway, as well as the MTRC Railway, for an initial period of 50 years from the Merger Date (this period is extendable pursuant to the MTR Ordinance and the Operating Agreement). The right to operate the KCRC Railway will end if the Franchise relating to the KCRC Railway is revoked;

(2) the grant by KCRC to the Company of the Service Concession to access and use the Concession Property and to provide the KCRC Services for an initial period of 50 years from the Merger Date (this period is extendable pursuant to the Service Concession Agreement);

(3) the provision by the Company of the KCRC Services to the Required Standards;

(4) the acquisition by the Company from KCRC of the Purchased Rail Assets;

(5) the transfer to the Company of the economic benefits of the Property Package; and

(6) other post-Merger Date arrangements between the Company and KCRC (such as the arrangements documented, amongst others, by the KSL Project Management Agreement, the West Rail Agency Agreement and the Outsourcing Agreement).

*Very substantial acquisition.* The Rail Merger and the entering into of the Transaction Agreements constitute a "very substantial acquisition" for the Company under Chapter 14 of the Listing Rules and are therefore, amongst other things, subject to the approval of the Independent Shareholders by a simple majority of those voting in person or by proxy.

*Connected transaction.* As at the Latest Practicable Date, the Government owned 76.67% of the MTRC Shares and, as such, for the purposes of the Listing Rules the Government is a "connected person" of the Company. KCRC, being wholly-owned by the Government, is also a "connected person" of the Company. As the Government and/or KCRC is a party to the Transaction Agreements, the Rail Merger involves "connected transactions" for the Company under Chapter 14A of the Listing Rules. Only the Independent Shareholders of the Company will have the right to cast their votes at the Merger EGM. Accordingly, the Government (and its "associates", as defined in the Listing Rules) will be required to abstain from voting with respect to the EGM Resolution.

This Circular contains, amongst other things, (1) details of the Rail Merger and the Transaction Documents; (2) a letter from the Independent Board Committee with its advice to the Independent Shareholders to vote in favour of the Rail Merger; (3) a letter from the Independent Financial Adviser containing its recommendations and advice to the Independent Board Committee and the Independent Shareholders to vote in favour of the EGM Resolution; and (4) the notice of the Merger EGM.

## 2. BACKGROUND TO THE RAIL MERGER

In February 2004, the Government invited the Company and KCRC to commence discussions relating to a possible rail merger on the basis of the following parameters:

(1) adoption of a more objective and transparent fare adjustment mechanism;

(2) abolition of the second boarding charge and review of the fare structure with the objective of reducing fares;

(3) early resolution of interchange arrangements for new rail projects under planning, notably the Shatin to Central Link;

(4) ensuring job security for frontline staff of both the Company and KCRC at the time of the rail merger; and

(5) provision of seamless interchange arrangements in the long run.

On 11 April 2006, the Government and the Company entered into the Memorandum of Understanding which, amongst other things, addressed each of the five parameters above, set out the structure and key terms of the Rail Merger and formed the basis upon which the Transaction Documents were agreed.

The Memorandum of Understanding recorded the understanding reached between the Company and the Government as to the structure and key terms of the Rail Merger as at 11 April 2006. These terms were not legally binding and created no legal obligations on either party as to the final structure or terms of the Rail Merger.

Following the signing of the Memorandum of Understanding, the Company, the Government and KCRC negotiated the terms of the Transaction Agreements for the implementation of the Rail Merger, which were entered into on the Signing Date (other than those which are to be entered into at a later date). The Rail Merger addresses the five parameters as follows:

***Parameter 1: Adoption of a more objective and transparent fare adjustment mechanism***

At present, both the Company and KCRC have fare autonomy, and they set their fares in accordance with prudent commercial principles having regard, amongst other things, to prevailing market conditions, competition from other transport modes and their respective financial objectives. One of the parameters set by the Government in February 2004 (as referred to above) was the adoption of a more objective and transparent fare adjustment mechanism. The Government set this parameter to address (a) the public concern that the process for adjustment of transport fares should be more objective and transparent, and should allow for reductions as well as increases in fares; (b) the concern of public transport operators that once fares are reduced, public pressure will render fare increases difficult, if not impossible, to implement (even when the economy is improving); and (c) the common concern of public transport operators and the Government that fare adjustments should not be politicised as it is not conducive to efficiency and social harmony.

Against this background, the Company and the Government have agreed upon a formulaic approach for determining future fare adjustments to replace fare autonomy after the Rail Merger. This has been incorporated into the Operating Agreement.

The Fare Adjustment Mechanism will provide that any adjustment to specified fares should be linked to changes in the Government Composite Consumer Price Index and changes in the Nominal Wage Index (Transport Services Sector) published by the Census & Statistics Department of Government, and taking into account a productivity factor.

The Fare Adjustment Mechanism will work as follows:

> "Overall weighted fare adjustment rate = 0.5 * △ CCPI + 0.5 * △ wage index - t"

where:

> "Overall weighted fare adjustment rate" is calculated based on the basket of specified "fares" on the Integrated Railway;
>
> "△ CCPI" means the yearly percentage change in the Government Composite Consumer Prices Index;
>
> "△ wage index" means the yearly percentage change in the Nominal Wage Index (Transport Services Sector); and
>
> "t" will be deemed to be zero in the first five years following the Merger Date. "t" will have a value of 0.1% starting from the sixth year following the Merger Date. The value of "t" will not be subject to review until after the ninth anniversary of the Merger Date under the agreed review mechanism for the FAM. If the Company keeps its fare related costs at the rate of inflation set out in the above formula, "t" (as from the sixth year following the Merger Date) will result in the Company's fare revenue increasing at a level less than that inflation rate. This will reduce the Company's real rate of return (being revenue less costs, after taking into account such inflation rate). "t" therefore acts as an incentive for the Company to achieve productivity gains in order to ensure its real rate of return does not diminish.

The Company also has the right to adjust certain individual fares within a range of ±5 percentage points from the overall weighted fare adjustment rate under certain circumstances.

Further details of the Fare Adjustment Mechanism are contained in the paragraph headed "Operating Agreement" in the Appendix to this Circular headed "Transaction Agreements".

***Parameter 2: Abolition of second boarding charge and review of the fare structure with the objective of reducing fares***

Although there has been a history of high level co-operation between the Company and KCRC, the MTRC Railway and the KCRC System are currently operated as separate systems. A combined railway network will achieve a degree of economies of scale and will facilitate the abolition of second boarding charges when passengers change from the KCRC Railway to the MTRC Railway (and vice versa). Synergies are expected to be realised from both revenue and operating costs, with the former mainly to be achieved through the broadening of the sales and distribution network and from railway/station-related businesses such as advertising, and the latter principally through the achievement of economies of scale in railway operation over time. The Company has reviewed its existing fare structures with a view to rationalising the fare levels for the Company in light of the potential synergies arising from the Rail Merger.

The Company shall, in respect of the Integrated Railway (with the exception of the Airport Express, Light Rail, cross-boundary trips to/from Lo Wu/Lok Ma Chau and intercity trains):

(i) remove the second boarding charge of HK$1-7 for adults, and remove the corresponding second boarding charge in respect of Concession Fares and Student Fares;

(ii) reduce all adult Octopus fares by HK$0.20;

(iii) reduce the adult fares for all journeys with fares at or above HK$12 by an additional HK$1;

(iv) for each adult journey of HK$12 or above, if (i) to (iii) above when combined result in less than a 10% fare reduction for that journey, procure that there shall be a further reduction to achieve a minimum of a 10% fare reduction for that journey;

(v) for each adult journey of between HK$8.50 and HK$11.90 (inclusive), if (i) and (ii) when combined result in less than a 5% fare reduction for that journey, procure that there shall be a further reduction to achieve a minimum of a 5% fare reduction for that journey;

(vi) procure that the dollar amount of reductions for Concession Fares shall be half of the adult fare reductions; and

(vii) procure that the dollar amount of reductions for Student Fares shall be half of the adult fare reductions for journeys taken wholly within the MTRC Railway, the dollar amount of reductions for Student Fares shall be the same as for the adult fare reductions for journeys taken wholly within the KCRC Railway and the percentage fare reductions for Student Fares shall be the same as the corresponding adult fare reductions for journeys involving an interchange between the MTRC Railway and the KCRC Railway.

This means that there will be a minimum of a 10% fare reduction for all passengers travelling on journeys with fares at HK$12 or above, and a minimum of a 5% fare reduction for all passengers travelling on journeys with fares between HK$8.50 and HK$11.90. In overall terms, a total of 2.8 million daily rail trips are expected to benefit from fare reduction from the Merger Date. About 340,000 journeys are expected to benefit from a minimum of a 10% fare reduction and another 1.16 million are expected to benefit from a minimum of 5% up to 10% fare reduction.The proposed fare reductions are made possible partly by synergies expected to be achieved as a result of the Rail Merger.

In addition, for one year commencing on the Merger Date, the Company shall provide an Octopus concessionary fare of HK$2 for all journeys on the Integrated Railway made by the elderly (being persons aged 65 or above) on Sundays and public holidays. The Company will maintain the status quo as at the date of the Memorandum of Understanding with respect to Student Fares discounts by continuing to provide a discount of 50% on Student Fares for the MTRC Railway and no discount on Student Fares for the KCRC Railway, subject to the Fare Adjustment Mechanism applying to the Student Fares from and including the Merger Date.

Furthermore, the Company has agreed that it will not increase fares to which the Fare Adjustment Mechanism applies until after 30 June 2009. For the period ending on the Merger Date, KCRC shall not increase fares for the KCRC Railway.

It is estimated that the above fare reductions will amount to an annual cost to the Company of HK$600 million.

***Parameter 3: Early resolution of interchange arrangements for new rail projects under planning, notably the Shatin to Central Link***

In 2002, KCRC was selected to proceed with the planning of the SCL project and, in 2004, submitted its draft final proposal ("**DFP**") to the Government. The DFP included the extension of East Rail across Victoria Harbour to Hong Kong Island and the extension of the MOS Rail to West Rail via East Kowloon. In addition, the Company and KCRC jointly developed a scheme for the SCL to be implemented should the Rail Merger proceed for the purpose of ensuring the early resolution of the interchange arrangements for the SCL.

According to the Transport and Housing Bureau, the SCL remains a committed project for implementation. It stated in a paper to the Legislative Council Panel on Transport dated 16 July 2007 (LC Paper No. CB(1)2058/06-07(01)): "*The Administration has promised to make a decision on the way forward, including the scheme and timetable for the SCL within six months after the completion of the legislative process for the rail merger*." Further information on the background and progress of the SCL is contained in the section of this Circular headed "Information on the Business of KCRC".

***Parameter 4: Ensuring job security for frontline staff at the time of the rail merger***

On the Merger Date, the Company shall sign, seal and deliver a deed poll in favour of Relevant Frontline Staff. The deed poll provides that the Company shall not terminate the employment contract of any Relevant Frontline Staff member for any reason that relates to the process of integrating the operations of the Company and KCRC pursuant to the Rail Merger.

According to the assessments made by the Company and KCRC, the Rail Merger could achieve an overall staffing synergy of 650-700 in number. This would create direct cost savings in a number of areas of the Company's business. However, it is also estimated that more than 1,300 vacancies will be created in the first three years after the Rail Merger through various means, including the commissioning of new railways and property management as well as through retirement and turnover.

The Company envisages that the majority of its and KCRC's existing staff would stay in their current jobs after the Rail Merger. Every effort will be made to re-deploy affected staff to available vacancies and, in order to effect this, a special team has been established to provide support to help staff concerned to settle into their new jobs after the Rail Merger.

From the Merger Date (and, in the case of KCRC staff, pursuant to the MTR Ordinance), staff of the Company and KCRC would be employed on their prevailing terms and conditions of employment, but it is expected that shortly after the Merger Date there would be a single set of terms and conditions of employment and grading structure for all staff of the Company as it would facilitate the integration of the human resources of the two corporations in the spirit of "One Company, One Team".

***Parameter 5: Provision of seamless interchange arrangements in the long run***

The integration of the operations of the two railway systems are expected to improve passenger convenience and reduce journey time. The Company has undertaken that it shall complete a specified programme of milestone dates and preparatory work relating to station modification and the provision of barrier free interchanges at Nam Cheong, Mei Foo and Kowloon Tong stations, the integration of operations at those stations and at Tsim Sha Tsui station, the integration of the ticketing systems for Octopus users and single journey ticket users and the establishment of an integrated communication coordination centre and hotline system. The external costs and expenses of implementing the seamless interchange programme up to the Merger Date shall be borne equally by the Company and KCRC, and each of them shall bear its own internal costs and expenses. All costs and expenses of the seamless interchange programme incurred on or after the Merger Date shall be borne by the Company.

## 3. THE RAIL MERGER PACKAGE AND CONSIDERATION

### The Rail Merger Package

Pursuant to the Transaction Documents (further details of which are contained in the paragraphs headed "Rail Merger Ordinance" and "Summary of Transaction Agreements" in this section of this Circular and in the Appendices to this Circular headed "Summary of the Rail Merger Ordinance" and "Transaction Agreements"), the Rail Merger includes, amongst other things:

- pursuant to the Sale and Purchase Agreement, the sale and purchase of the Purchased Rail Assets and the KCRC Subsidiaries;
- pursuant to the Property Package Agreements and the Sale and Purchase Agreement, arrangements for the transfer to the Company of the economic benefits of the Property Package;
- pursuant to the Rail Merger Ordinance, the expansion of the Franchise to enable the Company to operate the Integrated Railway under a single franchise for an initial period of 50 years from the Merger Date;
- pursuant to the Operating Agreement, the operation by the Company of the Integrated Railway as an integrated system;
- pursuant to the Service Concession Agreement, an arrangement under which, amongst other things:
  - — KCRC will grant the Service Concession to the Company for an initial period of 50 years in order to enable the Company to access, use and operate the Concession Property to provide the KCRC Services. The Service Concession will end if the Franchise relating to the KCRC Railway is revoked; and
  - — the Company will provide the KCRC Services to the Required Standards;
- pursuant to the KSL Project Management Agreement, an arrangement under which the Company will act as KCRC's agent in connection with the KSL under certain circumstances;
- pursuant to the West Rail Agency Agreement, an arrangement under which the Company will act as an agent for KCRC and the West Rail Subsidiaries, in connection with the development of properties at, adjacent to or above West Rail;
- pursuant to the US CBL Assumption Agreements, arrangements under which the Company will become jointly liable, together with KCRC, for certain of KCRC's obligations to the counterparties of the CBLs (indemnities in relation to which are contained in the Merger Framework Agreement and the US CBL Allocation Agreement);
- pursuant to the US CBL Allocation Agreement, arrangements delineating the rights and obligations between KCRC and the Company in respect of the exercise of joint rights and the performance of joint obligations under the terms of the CBLs;
- in accordance with the Liaison Committee Letter, provisions relating to material decisions of KCRC between the Signing Date and the Merger Date; and
- other transactions and matters as set out in the Merger Framework Agreement and the other Transaction Agreements.

The Company, the Government and KCRC have acknowledged that the Rail Merger and the Transaction Agreements comprise an integrated package of terms.

The Rail Merger excludes the Excluded Assets, which will be retained by KCRC. As discussed further in this Circular, the Rail Merger has been structured to ensure that the Company obtains the necessary rights to access, use and operate the Integrated Railway and the Property Package. The Excluded Assets are not required by the Company for these purposes.

### Payments

The Company will be required to pay to KCRC the following payments:

(1) *Initial payments:* Upfront Payment of HK$4.25 billion, payable under the Service Concession Agreement, being the upfront fee for the right to operate the Service Concession and the consideration for the Purchased Rail Assets, and Upfront Property Payment of HK$7.79 billion payable under the Merger Framework Agreement in consideration for the execution of the Property Package Agreements and the sale of the shares in the KCRC Subsidiaries under the Sale and Purchase Agreement, in each case payable on the Merger Date;

(2) *Fixed annual payments:* of HK$750 million payable under the Service Concession Agreement, for the right to use and operate the Concession Property for the operation of the Service Concession, in arrears on the day immediately preceding each anniversary of the Merger Date which falls during the Concession Period in respect of the 12 month period up to and including the date on which such payment falls due; and

(3) *Variable annual payments*: payable under the Service Concession Agreement, for the right to use and operate the Concession Property for the operation of the Service Concession, in each case, calculated on a tiered basis by reference to the amount of revenue from the KCRC System (as determined in accordance with the Service Concession Agreement) for each financial year of the Company. The applicable percentage will vary according to the amount of revenue from the KCRC System for the relevant financial year of the Company as follows: for the first HK$2.5 billion of revenue from the KCRC System, the applicable percentage will be 0.0%; for the next HK$2.5 billion, the applicable percentage will be 10.0%; for the next HK$2.5 billion, the applicable percentage will be 15.0%; for the revenue from the KCRC System above the first HK$7.5 billion, the applicable percentage will be 35.0%. The Variable Annual Payments will be payable annually in arrears within 60 days after the end of the relevant financial year of the Company (and will be adjusted if, following finalisation of the Company's audited accounts, the amount paid by the Company within the 60 day period referred to above is not correct). No Variable Annual Payment shall be payable in respect of the first 36 months following the Merger Date.

As a complete package deal, other than the payment elements described above, no specific allocation has been made between the various elements of the Rail Merger.

The payments set out above were determined by the Directors after arm's length negotiations with the Government and KCRC. In arriving at the consideration, the Directors did not place reliance on any one single factor but considered numerous factors as a whole, including financial considerations, such as capital expenditure requirements, credit ratios, discounted cash flow, market trading multiples, the Property Package and the payment structure, together with a broader range of issues including the strategic growth and market positioning of the Company and the heightened degree of certainty relating to the fares of the Company.

## 4. REASONS FOR AND BENEFITS OF THE RAIL MERGER

The Company stated in the announcement in relation to the signing of the Memorandum of Understanding on 11 April 2006 that, if the Rail Merger is implemented on acceptable terms, it would be beneficial to all stakeholders as it would provide an integrated regional and urban rail network for the people of Hong Kong with greater efficiency, increased convenience and enhanced connectivity, and provide room for fare adjustments. The Company considers that the terms of the Rail Merger provided in the Transaction Documents, which implement the Memorandum of Understanding, will be beneficial for the following principal reasons:

### Enhancement of Value

From the commencement of operations of the MTRC Railway in 1979, Hong Kong has been provided with a reliable, efficient and affordable urban mass transport system. Since the privatisation of the Company in October 2000, the success of the Company's business has continued and has been reflected in the increase in the Company's share price, together with the regular payment of dividends to the Shareholders.

As a result of the Rail Merger, there will be a significant increase to the revenue base of the Company. It is expected that such increase, together with the other benefits highlighted in the ensuing paragraphs of this section, will contribute to the accretion of earnings per Share ("**EPS**") and cashflow and enhancement to property of the Company as further explained below.

The analysis contained in this section of this letter provides an illustration of how the Company may have performed had the Rail Merger occurred on 1 January 2006 (save as otherwise stated).

*Earnings Accretion*

| | **2006 Underlying EPS**(Note 1) | **2006 Rail and related, and property rental and management business (pre-tax profit)** |
|---|---|---|
| The Company (as reported) | HK$1.08 | HK$1,174 million(Note 2) |
| Pro-forma (per Appendix VII) | HK$1.22 | HK$2,126 million |
| Accretion | 13.0% | 81.1% |

*Note 1:* The Company's 2006 underlying EPS of HK$1.08 is before change in fair value of investment properties net of related deferred tax ("**2006 Underlying EPS**"). If such change in fair value of investment properties net of related deferred tax is taken into account, the adjusted 2006 EPS on a pro-forma basis would be HK$1.55, representing an increase of 9.9% over the comparable EPS in respect of the year ended 31 December 2006 of HK$1.41.

*Note 2:* The 2006 pre-tax profit of the Company of HK$1,174 million relating to the rail and related, and property rental and management business is extracted from the Company's 2006 annual report as follows: profit before taxation of the Company of HK$9,169 million adjusted for pre-tax profit on property developments of HK$5,817 million and the change in fair value of investment properties of HK$2,178 million.

As shown in the above table, the 2006 pro-forma underlying EPS of HK$1.22 represents an increase of 13.0% when compared to the 2006 Underlying EPS of HK$1.08, assuming that the Rail Merger had been effective on 1 January 2006.

The accretion of 13.0% relating to the 2006 pro-forma underlying EPS has not taken into account (i) the proposed fare reduction; (ii) the implementation of the FAM; (iii) the Variable Annual Payment (which is not payable in respect of the first 36 months following the Merger Date); and (iv) estimated full synergies. The impact of each of items (i)-(iv) have been estimated to be as follows:

| | **HK$ Per Share**(Note 1) | **HK$ million** |
|---|---|---|
| (i) Fare reduction(Note 2) | -0.09 | -600 |
| (ii) FAM(Note 3) | +0.01 | +70 |
| (iii) Variable Annual Payment(Note 4) | -0.04 | -280 |
| (iv) Full synergies(Note 5) | +0.07 | +450 |

*Note 1:* HK$ per share is calculated as the effect of the amounts in the table per Share and is after taking into account the effect of taxation at 17.5%.

*Note 2:* Fare reduction of HK$600 million represents the Directors estimate of the impact of the relevant fare reduction provisions in the Merger Framework Agreement as disclosed to LegCo in September 2006. The elements which have been used as the basis for calculating this estimated fare reduction are set out in the paragraph headed "Parameter 2: Abolition of second boarding charge and review of the fare structure with the objective of reducing fares" in the section headed "Background to the Rail Merger" in this Letter from the Board.

*Note 3:* It is estimated that the application of the FAM would have given rise to a potential fare revenue increase of HK$70 million for the year ended 31 December 2006. However, as this is below the ±1.5% threshold required for implementation of fare adjustments, no fare adjustment would be made under the FAM. Under the FAM, adjustments not applied in any year, as a result of being below the ±1.5% threshold, would be carried over to be applied to the next year's FAM calculations. The basis for this FAM estimation is also set out in Note 8 (i) of section (A)(VII) of the Appendix to this Circular headed "Financial Information of the Enlarged Group".

*Note 4:* Variable Annual Payment is calculated on the basis of the formula in the Service Concession Agreements applied to the Directors' estimate of relevant KCRC System revenues for the year ended 31 December 2006 of HK$5,200 million. The basis for the estimation of this Variable Annual Payment is also set out in Note (ii) of section (A)(VII) of the Appendix to this Circular headed "Financial Information of the Enlarged Group".

*Note 5:* It is expected that estimated synergies of HK$450 million per annum will be fully realised over the first three years after the Merger Date, based on a joint study by the Company and KCRC.

After taking into account all the above, the Directors also consider the potential accretion over the 2006 Underlying EPS to be notable.

It should be noted that in the EPS calculations, interest costs relating to the HK$4.91 billion consideration for the acquisition of development rights in respect of eight properties (included, amongst other things, in the Property Package) has been charged but future potential profits arising from such development rights have not been accounted for.

For the Company's rail and related, and property rental and management businesses, the pre-tax profit from such businesses would have increased by approximately 81.1% on a pro-forma basis for the year ended 31 December 2006. After taking into account the items set out in the table above, the Directors also consider the accretion over the comparable 2006 pre-tax profit of HK$1,174 million to be very significant. In this regard, it is worth noting that there would likely be further earnings accretion potential in KCRC's rail and related operations as a result of KCRC's committed new lines recently commissioned and to be commissioned (such as LMCSL and KSL) as well as the increase over time of KCRC's new lines already in operation (such as MOS Rail and WR).

*Cashflow Accretion*

Consolidated cash inflow from operating activities of KCRC of HK$2,719 million (based on KCRC audited accounts for the year ended 31 December 2006 and included in the pro-forma combined cashflow statement for year ended 31 December 2006 in Appendix VII) represents an increase of approximately 50.5% over the Company's consolidated net cashflow generated from operating activities for the year ended 31 December 2006 of HK$5,387 million. The consolidated cash inflow from operating activities of KCRC of HK$2,719 million has not taken into account (i) the Fixed Annual Payment; (ii) capital expenditure of HK$389 million to maintain and upgrade the KCRC System in the year ended 31 December 2006; (iii) the estimated proposed fare reduction; (iv) the estimated effect of the FAM; (v) the estimated Variable Annual Payment (which is not required to be paid in respect of the first 36 months following the Merger Date); and (vi) estimated full synergies. The impact of each of items (i) to (vi) on rail and related cashflows has been estimated to be as follows.

| | | **HK$ million** |
|---|---|---|
| (i) | Fixed Annual Payment | -750 |
| (ii) | Capital expenditure | -389 |
| (iii) | Fare reduction | -600 |
| (iv) | FAM | +70 |
| (v) | Variable Annual Payment | -280 |
| (vi) | Full synergies | +450 |

After taking into account all the above, the Directors also consider the increase to the Company's consolidated cashflow for 2006 arising from the operating activities of KCRC to be very significant.

*Enhancement to Property*

Based on JLL's professional valuation of the property development rights and investment properties, there would be a pre-tax surplus of HK$2,824 million (HK$2,330 million post-tax assuming the effect of taxation at 17.5%) above the consideration payable by the Company in respect of such rights and properties of HK$7,750 million, which represents an increase of 36.4%.

*Dividends*

When the Board considers the amount of dividends to be declared, it takes into consideration, amongst other things, the financial performance of the Company, the earnings for the year concerned, the Company's cash flow and its capital expenditure requirements. As outlined above, the financial effects of the Rail Merger are such that, on a pro-forma basis and even after taking into account the impact of the items noted under "Earnings Accretion" and "Cashflow Accretion" above, both earnings and cash flow would be increased.

**Benefits to the Rail Business**

Expanded Rail Network and Increased Rail Patronage. The Rail Merger will provide the Company with a significant growth opportunity through an expanded rail network, which will extend the Company's operations within Kowloon and into the New Territories. The expansion will also extend the Company's operations into the Mainland, providing, amongst other things, a platform to further expand its operations into the Pearl River Delta region. The route length of the Company's rail network after the Rail Merger will be increased by 131.9% from 91 km to 211 km. With 2006 figures as a reference, the expanded rail network (i) would bring a 65.9% increase in the Company's patronage from 876 million to 1,453 million (which, however, includes approximately 102 million passengers who interchange between the two systems and which figure will, from the Merger Date, be deducted because passengers who interchange between the two systems will be counted as having made only one journey on the Integrated Railway) and (ii) a 70.5% fare revenue growth from HK$6,523 million to HK$11,121 million (excluding the estimated impact of the proposed fare reduction of HK$600 million and the FAM). The expanded rail network will increase the Company's franchised public transport market share in Hong Kong from approximately 25% to approximately 40%.

Beyond immediate rail network growth, the Rail Merger will also bring future expansion in the form of the KSL, and potentially, possible future railway lines such as Northern Link and Express Rail Link, as well as the SCL.

It is further anticipated that with the integration of the two railway networks, allowing for seamless journeys from one end of the Integrated Railway to the other, together with lower fares and improved planning, design and construction of new extensions, the Company will have the ability to enhance its competitiveness over other transport providers in Hong Kong and further increase its patronage.

The Company's rail-related business will also benefit from the Rail Merger which will be integrated with KCRC's rail-related activities such as its duty free business, advertising and telecommunications. Non-fare rail-related revenues would increase by 50.6% from HK$1,542 million to HK$2,322 million (based on an aggregation of the relevant revenues of the Company and KCRC for the year ended 31 December 2006).

The Company's current Franchise runs for a term of 50 years from June 2000. It should be noted that, following the Rail Merger, the Company's Franchise relating to the Integrated Railway will be extended to run for a term of 50 years commencing on the Merger Date.

Objective Fare Adjustment Mechanism. One of the parameters set by the Government for the Rail Merger was the introduction of the proposed Fare Adjustment Mechanism (further details on the Fare Adjustment Mechanism are contained in the paragraph headed "Background to the Rail Merger" in this section of this Circular). The adoption of the Fare Adjustment Mechanism, being a direct-drive formula, will require the Company to adjust its fares according to a pre-determined formula based on changes in the composite consumer price index and wage index, and a productivity factor. As a result, although fares may be reduced as a result of fluctuations in such factors, fares may also be increased. The Company believes that the Fare Adjustment Mechanism offers a predictable, objective and transparent solution to the question of fare adjustment as it is a direct-drive formula. Consequently, it gives the Company a measure of certainty with respect to its fares. The Company therefore considers that the Fare Adjustment Mechanism will be beneficial to the Company particularly in the long term.

Creation of Synergies. Following the Rail Merger, the Company will operate and manage the combined businesses of the Company and KCRC in an integrated manner. By applying best practices to the expanded rail network, it is expected that there will be a creation of both cost and revenue synergies in a number of business areas. The Rail Merger is expected to create estimated annual synergies of up to HK$450 million once all the proposed synergy programmes are fully implemented which is expected to be over the first three years after the Merger Date. These identified synergies are based on an extensive joint study by the Company and KCRC. Although there are expected to be some synergies from further revenue enhancements in combining the fare and non-fare businesses of the Company and KCRC, the majority of the synergies are cost synergies which are expected to come from the following three areas:

- transfer of best practices and operational efficiencies, such as improved scheduling of engineering work, implementation of total station operation and group station management and combining operations at interchange stations;

- procurement synergies, such as contract bundling, wider implementation of e-tendering and increased use of alternative sourcing; and
- streamlining of overlapping activities and reduction of overheads.

**Benefits to the Property Business**

One of the key ingredients of the Company's success has been its Rail-and-Property Model. This model has enabled the Company to develop properties and build communities along and adjacent to the railway. As part of the Rail Merger, the Company will acquire the economic benefits of the Property Package which comprises property development rights, investment properties and property management rights (further details on the Property Package are contained in the paragraph headed "Property Package Agreements" in the Appendix to this Circular headed "Transaction Agreements"). It should be noted that there would be a pre-tax surplus of HK$2,824 million (HK$2,330 million post-tax) based on the difference between (i) the valuation made by JLL of the property development rights and investment properties as at 31 July 2007 and (ii) the Company's acquisition cost for such rights and properties.

The Property Package will not only provide the Company with an increased land bank, but will also increase the Company's recurrent income from its investment property portfolio and property management rights. The Company's development land bank (being development rights and property development interests in relation to which property development profits have not been accounted for up to 30 June 2007) will increase by 54.3% from 23.2m sq ft to 35.8m sq ft (gross floor area). The Property Package will also enable the development of properties along and adjacent to the MTRC Railway and KCRC System to be managed in a co-ordinated manner.

The current investment properties owned by the Company amount to approximately 2.7m sq ft gross and will increase to approximately 3.6m sq ft gross after the opening of Phase I of Elements at Kowloon Station, which is scheduled to be in the fourth quarter of 2007. As a result of the Rail Merger, the investment properties owned by the Company will further increase by about 22% from 3.6m sq ft gross to 4.4m sq ft gross. Revenue from investment properties and management would increase by 16.0% from HK$1,412 million to HK$1,638 million (based on an aggregation of the revenues of the Company and KCRC for the year ended 31 December 2006).

In addition, the Company will take up KCRC's role as development agent for the Government in respect of West Rail properties (which comprises a total gross floor area of about 24.3m sq ft). The Company will receive from the West Rail Subsidiaries, in addition to cost recovery, a fee of 0.75% of the gross sales proceeds in respect of the unawarded West Rail development sites (comprising approximately 22.7m sq ft gross floor area) and 10% of the relevant profits accrued to the West Rail Subsidiaries under the development agreement in respect of the awarded West Rail development site (comprising approximately 1.6m sq ft gross floor area).

**Benefits of the Rail Merger Transaction Structure**

The rail component of the Rail Merger has been structured as a Service Concession, thereby allowing the Company to acquire the rights to access and operate the KCRC System and related assets whilst not assuming KCRC's existing debts (except as joint co-obligor with KCRC in relation to the CBLs, in respect of which the Company will receive indemnities from both Government and KCRC, as further described in the section headed "KCRC Cross Border Lease Agreements" in the Appendix to this Circular headed "Transaction Agreements") nor paying a significantly greater upfront payment. In addition, the transaction structure will also be beneficial to the Company in terms of cash flow, earnings enhancement and financial flexibility to the Company. The structure also offers some protection against future adverse changes in patronage and fares of the KCRC System as explained below.

The payment structure of the rail component includes the Upfront Payment, the Fixed Annual Payments and the Variable Annual Payments for the Concession Period. This payment structure alleviates the Company of the need to finance the entire transaction with a large upfront payment. It also allows the Company to fund a significant portion of the transaction consideration, being the Fixed Annual Payments and the Variable Annual Payments, from internal resources each year and debt. With no Variable Annual Payments to be made in respect of the first 36 months following the Merger Date, the structure further enhances the cashflow and earnings of the Company during these initial years after the Merger Date.

*Credit Profile*

The strength of the Company's post-Rail Merger balance sheet can be demonstrated by the comparison of the pro-forma ratios with the pre-Rail Merger ratios below:

| | The Company | Pro-forma | |
|---|---|---|---|
| | | Excluding capitalised Fixed Annual Payments (Note 2, 3) | Including capitalised Fixed Annual Payments (Note 2, 4) |
| Gearing ratio as at 30 June 2007 (Net debt/equity)(Note 1) | 30.8% | 44.5% | 57.7% |

*Note 1:* Net debt/equity is defined as loans and other financing (i.e. loans, obligations under finance leases and bank overdrafts) less cash and cash equivalents as a percentage of the total equity attributable to Shareholders. The Pro-forma figures are calculated with respect to the balance sheet set out in the Pro-forma Financial Information in Appendix VII, assuming the Rail Merger occurred on 30 June 2007.

*Note 2:* During the Concession Period, the Company will be required to pay Fixed Annual Payments of HK$750 million to KCRC. The net present value of such committed payments will be capitalised as a concession asset on the balance sheet and will be amortised over the term of the Service Concession and amount to HK$10,687 million as set out in the Pro-forma Financial Information in Appendix VII.

*Note 3:* The pro-forma gearing ratio excluding capitalised Fixed Annual Payments of 44.5% is calculated from the pro-forma balance sheet at 30 June 2007 in the unaudited Proforma Financial Information in Appendix VII as follows: loans and other financing of HK$36,447 million less cash and cash equivalents of HK$563 million as a percentage of equity of HK$80,688 million.

*Note 4:* The pro-forma gearing ratio including capitalised Fixed Annual Payments of 57.7% is calculated from the pro-forma balance sheet at 30 June 2007 in the unaudited Proforma Financial Information in Appendix VII as follows: loans and other financing of HK$36,447 million and capitalised Fixed Annual Payments of HK$10,687 million less cash and cash equivalents of HK$563 million as a percentage of equity of HK$80,688 million.

| | The Company | Pro-forma | |
|---|---|---|---|
| | | Excluding interest on capitalised Fixed Annual Payments(Note 2) | Including interest on capitalised Fixed Annual Payments(Note 3) |
| Interest cover for year ended 31 December 2006(Note 1) | 6.7x | 6.1x | 4.6x |

*Note 1:* Interest cover is defined as operating profit before depreciation divided by gross interest and finance charges before interest expenses capitalised and interest income from loan to a property developer. Pro-forma figures are based on the Pro-forma Financial Information in Appendix VII, assuming the Rail Merger had occurred on 1 January 2006.

*Note 2:* The Pro-forma interest cover excluding interest on capitalised Fixed Annual Payments of 6.1x is calculated from the pro-forma profit and loss account for the year ended 31 December 2006 in the unaudited Proforma Financial Information in Appendix VII as follows: operating profit before depreciation of HK$13,591 million, divided by interest and finance charges of HK$2,696 million, less interest on capitalised Fixed Annual Payments of HK$721 million, add interest capitalised of HK$126 million (per audited accounts of the Company at 31 December 2006), and add interest income from loan to a property developer of HK$123 million (per audited accounts of the Company at 31 December 2006).

*Note 3* Pro-forma interest cover including interest on capitalised Fixed Annual Payments of 4.6x is calculated from the pro-forma profit and loss account for the year ended 31 December 2006 in the unaudited Proforma Financial Information in Appendix VII as follows: operating profit before depreciation of HK$13,591 million, divided by interest and finance charges of HK$2,696 million, add interest on capitalised of HK$126 million (per audited accounts of the Company at 31 December 2006), and add interest income from loan to a property developer of HK$123 million (per audited accounts of the Company at 31 December 2006).

Although the Company's gearing on a pro-forma basis as at 30 June 2007 will increase to 57.7% (including capitalised Fixed Annual Payments) from 30.8%, this is similar to the gearing levels experienced by the Company in certain previous years (e.g. 2002: 59.3% and 2003: 55.2%). The Company's pro-forma interest cover for 2006 will fall to 4.6x (including interest on capitalised Fixed Annual Payments) from 6.7x before the Rail Merger. The Board regards both the pro-forma gearing ratio and interest cover to be acceptable. It is also expected that the increased cashflow from the Rail Merger will reduce the gearing and enhance interest cover levels over time.

The above gearing and interest cover ratios have not taken into account (i) the fare reduction, (ii) the implementation of the FAM, (iii) the payment of the Variable Annual Payment and (iv) full synergies (estimated at HK$450 million and expected to be fully realised over the first three years after the Merger Date). The Directors do not consider that the items (i) to (iv) would have a material impact on the above figures.

On 26 July 2007 Moody's upgraded the Company's credit ratings to Aa2 and on 16 July 2007 and 4 July 2007 respectively Standard and Poor's and Rating and Investment Inc. announced that they had affirmed the Company's credit ratings.

*Variable Annual Payments*

It is important to note that the Variable Annual Payments are directly linked to the revenue attributable to the KCRC System and form an important part of the total consideration for the Rail Merger. Such Variable Annual Payments will provide the Company with a certain degree of protection against the risks associated with future adverse changes in the KCRC System Revenue as the amount of the Variable Annual Payments will vary with the revenue attributable to the KCRC System.

*Financing of KSL*

KSL will be incorporated into the Integrated Railway as Concession Property upon its completion, while the financing of the construction of KSL will remain with KCRC even after the Rail Merger. This arrangement will therefore enable the Company to access and operate KSL without the need to incur capital expenditure required for its construction. It should be noted that in the case of KSL, the Company will act as KCRC's agent in relation to the construction in return for a fee (further details of the KSL Project Management Agreement are contained in the paragraph headed "KSL Project Management Agreement" in the Appendix to this Circular headed "Transaction Agreements").

*Treatment of SCL*

In the case of SCL, the decision as to whether it proceeds remains with the Government. According to the Transport and Housing Bureau, the SCL remains a committed project for implementation. It stated in a paper to the LegCo Panel on Transport dated 16 July 2007 (LC Paper No. CB(1)2058/06-07(01)): "*The Administration has promised to make a decision on the way forward, including the scheme and timetable for the SCL within six months after the completion of the legislative process for the rail merger*." Under the terms of the Rail Merger, if, in its absolute discretion, the Government decides to implement the SCL, it will be treated in the same way as a New Separate Project in accordance with the Operating Agreement (further details of New Separate Projects are contained in the paragraph headed "Operating Agreement" in the Appendix headed "Transaction Agreements"), except that the invitations referred to therein shall be to the Company only. The Company recognises that, if the SCL were to become incorporated into the Integrated Railway (whether under the concession approach or the ownership approach), certain benefits would accrue to the Company from its ability to invest in and/or operate SCL rather than it being owned or operated by a third party. Such benefits include the increase in the Integrated Railway's catchment area which could lead to increased patronage, relief of expected capacity constraints caused by the anticipated congestion on the Nathan Road corridor, and assistance in increasing the Company's market share of cross-harbour transport.

**Benefits to other Stakeholders**

As well as providing financial and operational benefits to the Company, the Rail Merger has been structured so as to satisfy the Government's "Five Parameters" (further details of Government's "Five Parameters" are contained in the paragraph headed "Background to the Rail Merger" in this section of this Circular).

*Retention of Employees*

The Rail Merger will give the Company a greater pool of experienced employees to staff its business requirements. The continued employment of both the Company's and KCRC's employees will be an essential element for the success of the Rail Merger integration process and the future of the Integrated Railway. According to the assessments made by the Company and KCRC, the Rail Merger could achieve an overall staffing synergy of 650-700 in number. This would create direct cost savings in a number of areas of the Company's business. However, it is also estimated that more than 1,300 job vacancies will be created in the first three years after the Rail Merger through various means, including the enlargement of the property related business, the commissioning of new railways, retirement and turnover. A number of measures have been established by the Company regarding employees during the Rail Merger process. Further details of these measures are contained in the paragraph headed "The Company Post-Rail Merger and Future Plans" in this section of this Circular.

*Benefits to the Public*

The Government has stated to LegCo that an enhanced railway service resulting from the Rail Merger will encourage cross-district labour movements and in turn stimulate a series of economic and employment activities. The Rail Merger is expected to generate synergies to support the reduction in railway fares including the introduction of immediate fare reductions. The better interchanging arrangements brought about by an integrated railway network are expected to improve passenger convenience and travelling time, which are in line with the sustainability principles of providing a safe, accessible and efficient transport system. The Rail Merger is therefore expected not only to improve the growth prospects and profitability of the Company, but also to create an integrated regional and urban rail network for the people of Hong Kong with greater efficiency, increased convenience and enhanced connectivity. In this way, the Rail Merger can be seen as reinforcing the principle that railways are the backbone of public transport in Hong Kong.

## 5. SUMMARY OF TRANSACTION AGREEMENTS

Set out below is a summary of each of the principal Transaction Agreements. A more detailed description of each of these documents is contained in the Appendix to this Circular headed "Transaction Agreements". Full copies of each are also available for inspection at MTR Tower, Telford Plaza, Kowloon Bay, from the date of this Circular up to and including the date of the Merger EGM.

Each of the documents (other than the Liaison Committee Letter and the Land Comfort Letter) set out below has been entered into by the Company, but is conditional upon the Conditions having been satisfied including the approval of the Transaction Agreements by the Independent Shareholders (further details of the Conditions are contained in the paragraph headed "Conditions precedent to the Rail Merger" in this section of this Circular).

### Merger Framework Agreement

The Merger Framework Agreement was entered into on the Signing Date between the Company, KCRC and the Secretary and the Secretary for Financial Services and the Treasury for and on behalf of the Government.

The Merger Framework Agreement contains provisions for the overall structure and certain specific aspects of the Rail Merger, including in relation to:

- The seamless interchange programme
- Corporate governance of the Company post-Rail Merger
- Payments relating to property enabling works
- Arrangements relating to the establishment of a rolling programme on the level of flat production arising from tenders for railway property development
- Arrangements in relation to the assessment of land premium amounts
- Arrangements in relation to the employees of the Company and KCRC, including provisions preventing the Company from terminating the employment of Relevant Frontline Staff for any reason that relates to the process of integrating the operations of the Company and KCRC
- The implementation of certain fare reductions

- Arrangements in relation to the proposed Shatin to Central Link
- KCRC's continuing responsibility for its existing financing arrangements
- Treatment of KCRC's CBLs
- The allocation of liability for any pre-Rail Merger and post-Rail Merger claims by third parties
- The Company's retention of its English name and (pursuant to the Rail Merger Ordinance) the change of its Chinese name to "香港鐵路有限公司".

**Service Concession Agreement**

The Service Concession Agreement was entered into on the Signing Date between the Company and KCRC.

The Service Concession Agreement contains provisions in relation to the grant and operation of the Service Concession, including in relation to:

- The grant of the Service Concession to the Company to access, use and operate the Concession Property (other than KCRC Railway Land referred to immediately below)
- The grant of a licence to access and use certain KCRC Railway Land
- The term (being an initial period of 50 years from the Merger Date) of the Service Concession and redelivery of the KCRC System upon expiry or termination of the Concession Period. The Service Concession will end if the Franchise relating to the KCRC Railway is revoked
- The provision of the KCRC Services by the Company to the Required Standards applicable to the KCRC Services
- The payment of the Upfront Payment of HK$4.25 billion, the Fixed Annual Payments and the Variable Annual Payments
- KCRC remaining the legal and beneficial owner of the Concession Property as at the Merger Date (known as "Initial Concession Property") and the Company being the legal and beneficial owner of Additional Concession Property
- The regime for compensation payable by KCRC to the Company if Additional Concession Property is returned to KCRC at the end of the Concession Period
- The rights and restrictions of the Company and KCRC in relation to the Concession Property (including, in relation to operation and maintenance, disposals, security, parting with possession, non-interference and insurance)
- The arrangements in relation to Intellectual Property Rights
- Subject to certain conditions, the Company bearing all risks, liabilities and/or costs whatsoever associated with or arising from the Concession Property and the land on which any of the Concession Property is located during the Concession Period
- The arrangements for the return of Concession Property at the end of the Service Concession and mutual access arrangements which would be applicable if the Service Concession is terminated but the Company continues to operate the MTRC Railway.

**Sale and Purchase Agreement**

The Sale and Purchase Agreement was entered into on the Signing Date between the Company and KCRC.

The Sale and Purchase Agreement provides the terms pursuant to which the Company will acquire the Purchased Rail Assets from KCRC and includes other terms relating to intellectual property, apportionment, receivables, certain provisions relating to employees and sets out the representations and warranties given by KCRC in relation to the Purchased Rail Assets. The consideration for the sale of the Purchased Rail Assets (excluding the shares in the KCRC Subsidiaries) forms part of the Upfront Payment of HK$4.25 billion. The consideration for the sale of the shares in the KCRC Subsidiaries (which subsidiaries will hold, amongst other things, the Category 1A Properties and act as property managers) forms part of the consideration for the Property Package.

### Operating Agreement

The Operating Agreement was entered into on the Signing Date between the Company and the Secretary for and on behalf of the Government as contemplated in the MTR Ordinance.

The Operating Agreement is based on the Existing Operating Agreement. The Operating Agreement differs from the Existing Operating Agreement to provide for, amongst other things, the nature of the combined MTRC Railway and KCRC Railway. The Operating Agreement includes terms relating to:

- The extension of the Franchise
- The requirements on the Company in relation to:
  - Electrical power supply
  - Control centres
  - Monitoring environmental conditions
  - Accommodation, facilities and means of communication for the Hong Kong Police Force on the railway and the railway premises
  - Procedures relating to the notification of the Commissioner for Transport and the Commissioner of Police in circumstances such as emergency closure of stations
  - Hours of operation and service capacity
  - Performance requirements
  - Customer service pledges
  - Safety management
  - Property development rights and land premium amounts
  - Compensation which may be payable under the MTR Ordinance to the Company in relation to a suspension, expiry or termination of the Franchise
- The Fare Adjustment Mechanism
- A framework for the award of new projects and the operation and ownership structure of new railways

### KSL Project Management Agreement

The KSL Project Management Agreement was entered into on the Signing Date between the Company and KCRC.

Pursuant to the terms of the KSL Project Management Agreement, the Company is appointed:

- To manage the performance of KCRC's principal obligations to the Government in relation to the design and construction of the KSL (other than obligations relating to payment)
- To act as the engineer under the various KSL construction contracts
- To act as KCRC's representative under the various KSL consultancy agreements
- To act as KCRC's agent in connection with the KSL under certain circumstances

The Company itself will not construct, nor be responsible for the costs of, the KSL works.

In return for the performance of these services, the Company will receive a project management fee of approximately HK$680 million and, if the construction of the KSL is completed ahead of time and under budget, an incentive payment (calculated with reference to the amount by which the final outturn cost of the project is under budget) of up to HK$110 million. The KSL Project Management Agreement was negotiated on an arms' length basis and is on no less than normal commercial terms. The current internal KCRC budget for project management costs was analysed in detail and formed the basis of the fee to be received by the Company.

### West Rail Agency Agreement

The West Rail Agency Agreement and related agreements were entered into on the Signing Date between the Company, KCRC and certain KCRC subsidiary companies (the "**West Rail Subsidiaries**").

Pursuant to the terms of the West Rail Agency Agreement, the Company will be appointed:

- To act as KCRC's agent, and donee under powers of attorney, to exercise certain rights and perform certain obligations relating to specified development sites along West Rail
- To act as agent for, and donee under powers of attorney from, each of the West Rail Subsidiaries to exercise certain rights and perform certain obligations relating to specified development sites along West Rail

The Company will receive an agency fee of 0.75% of the gross sale proceeds in respect of the unawarded West Rail development sites and 10% of the net profits accrued to the West Rail Subsidiaries under the development agreements in respect of the awarded West Rail development sites. The Company will also recover from the West Rail Subsidiaries its costs (including internal costs) incurred in respect of the West Rail development sites. The West Rail Agency Agreement was negotiated on an arms' length basis and is on no less than normal commercial terms.

### Outsourcing Agreement

The Outsourcing Agreement was entered into on the Signing Date between the Company and KCRC.

After the Merger Date, for a period of two years, KCRC will, pursuant to the terms of the Outsourcing Agreement, outsource certain financial and administrative functions to the Company.

Pursuant to the terms of the Outsourcing Agreement, the Company will:

- Provide a number of financial and administrative services to KCRC
- Provide certain staff to enable KCRC to operate after the Rail Merger
- Receive an annual fee of not more than HK$20 million from KCRC

The scope of the services to be provided by the Company will include services relating to treasury, financial control, information technology, company secretarial, legal and other corporate functions, human resources, office administration and management of claims. The Outsourcing Agreement was negotiated on an arms' length basis and is on no less than normal commercial terms. A detailed breakdown of the services to be provided and the manpower required to provide such services was analysed and formed the basis on which the fee was calculated.

### Property Package Agreements

The Property Package Agreements comprise each of the documents and arrangements which are required to be executed by the Company and/or the Government and/or KCRC to effect the agreed arrangements in respect of the Property Package.

For the purposes of the Property Package Agreements, the Property Package has been grouped into four categories. The types of property comprised in each category are as follows:

- *Category 1 Properties*: Category 1 Properties are investment properties comprising residential units, commercial accommodation and car parking spaces currently held by KCRC under private treaty grants ("**PTGs**") granted by the Government.

  Certain Category 1 Properties (being the Category 1B Properties) will be assigned by KCRC to the Company. The other Category 1 Properties (being the Category 1A Properties) will be acquired by the Company through its acquisition of the KCRC Subsidiaries under the Sale and Purchase Agreement.

- *Category 2 Properties*: Category 2 Properties are investment properties comprising residential and commercial accommodation and car parking spaces currently held by KCRC under vesting deeds pursuant to the KCRC Ordinance. As the Category 2 Properties are held pursuant to the KCRC Ordinance (and not under PTGs or the Government leases), they do not have lot numbers ascribed to them by the Lands Department and therefore (unlike properties held under PTGs or the Government leases) cannot be transferred from KCRC to the Company by way of assignment.

Arrangements have been put in place under which the Government will grant Government leases in respect of the Category 2 Properties (so that the Category 2 Properties can be owned by the Company (and the railway part of the relevant Government leases can be owned by KCRC)). This will be effected by the Government granting Government leases:

(i) (in respect of the Category 2A Properties) to KCRC, with a subsequent transfer of the relevant portion of the non-railway parts to the Company; and

(ii) (in respect of the Category 2B Property) to the Company.

Until the grant of such Government leases, interim arrangements will be put in place to ensure the Company receives the income derived from the Category 2 Properties as from the Merger Date.

- *Category 3 Properties*: Category 3 Properties are specified development sites currently held by KCRC under PTGs where joint venture agreements have been entered into between KCRC and developers.

  The Company has entered into agreements with KCRC in respect of each Category 3 Property, under which the Company will manage the relevant Category 3 Property (and exercise and perform KCRC's rights and obligations under the joint venture agreements) in return for a fee from KCRC. The amount of the fee in respect of each Category 3 Property is expected to be substantially equal to the profits made by KCRC in respect of such Category 3 Property (after deducting certain initial and upfront payments and a contribution towards KCRC's consultant's costs, in each case paid or to be paid by the relevant developer to KCRC).

- *Category 4 Properties*: Category 4 Properties are specified potential development sites which the Government has undertaken (subject to payment of land premium and agreement of the PTG conditions) to grant to the Company by way of PTGs. The Company shall be obliged to transfer the railway parts of the potential development sites to KCRC.

- *Metropolis Equity Sub-participation Agreement*: The Metropolis Equity Sub-participation Agreement obliges KCRC to act on the Company's instructions, and pay to the Company any distributions, or proceeds of sale, relating to its shareholding in the property management company The Metropolis Management Company Limited ("**Metropolis**"). KCRC has agreed to transfer other KCRC property management companies to the Company under the terms of the Sale and Purchase Agreement. The issued share capital of Metropolis is 25,500 A shares (which are held by KCRC) and 24,500 B shares (which are held by Cheung Kong Property Management Limited). Metropolis' business is property management.

**Liaison Committee Letter**

The Liaison Committee Letter was issued on the Signing Date by KCRC, the terms of which were acknowledged and agreed to by the Company and the Government.

The letter sets out the agreement between the parties regarding a "Liaison Committee" established for the purposes of governing certain matters of KCRC between the Signing Date and the Merger Date. The Liaison Committee comprises the same number of members from KCRC, the Company and Government.

**Land Comfort Letter**

A letter from the Government to KCRC was signed on 3 August 2007, pursuant to which the Government has agreed to extend the period of certain of KCRC's land interests during the Concession Period, subject to the necessary approvals and procedures, to coincide with the duration of the Service Concession.

**KCRC Cross Border Lease Agreements**

*US CBL Assumption Agreements*

Separate US CBL Assumption Agreements are expected to be entered into with respect to each CBL on or prior to the Merger Date.

Pursuant to each US CBL Assumption Agreement, the Company will undertake to perform, on a joint and several basis with KCRC, the obligations of KCRC under the respective CBLs. As a result thereof, the Company will generally become liable to the CBL counterparties in respect of KCRC's obligations under the CBLs and have the right to exercise certain of KCRC's rights under the CBLs.

*US CBL Allocation Agreement*

The US CBL Allocation Agreement is expected to be entered into on or before the date that the Company enters into a US CBL Assumption Agreement. Pursuant to the US CBL Allocation Agreement, rights, obligations and responsibility for risks relating to the CBLs will be delineated and allocated between KCRC and the Company (each of which will be jointly and severally liable to specified CBL counterparties, as referred to in the paragraph above headed "US CBL Assumption Agreements").

It is intended that, as between the Company and KCRC, (i) the Company will be responsible for the "MTRC Obligations" and certain "Common Obligations" (as more particularly described in the section headed "KCRC Cross Border Lease Agreements" in the Appendix to this Circular headed "Transaction Agreements").

The Company and KCRC will each make representations under the US CBL Allocation Agreement, which will include, in the case of those to be made by KCRC, representations with respect to the status of the CBLs.

The Company and KCRC will each agree to indemnify each other for losses (as more particularly described in the section headed "KCRC Cross Border Lease Agreements" in the Appendix to this Circular headed "Transaction Agreements").

## 6. CONDITIONS PRECEDENT TO THE RAIL MERGER

The Transaction Agreements are conditional upon the fulfilment of, among other things, the following conditions:

(1) the passing of the EGM Resolution by the Independent Shareholders prior to the Merger Date; and

(2) each of the other Transaction Agreements (other than certain documents which will be entered into after the Merger Date) becoming effective on the Merger Date.

## 7. RAIL MERGER ORDINANCE

On 8 June 2007, LegCo approved the Rail Merger Ordinance which will come into operation on the Merger Date. The Rail Merger Ordinance, amongst other things, amends the KCRC Ordinance and the MTR Ordinance to provide the necessary legislative framework for the Rail Merger (further details of the Rail Merger Ordinance is contained in the Appendix to this Circular headed "Summary of the Rail Merger Ordinance").

The Merger Date is to be appointed by the Secretary.

Each of the Company and KCRC has acknowledged that the Secretary has an absolute and unfettered discretion as to the appointment of the Merger Date and has agreed that neither of them has any recourse whatsoever against the Secretary or the Government in respect of the timing of appointment of the Merger Date or any decision not to appoint a Merger Date.

The Company has been advised of, and recognises, the Government's position that the appointment of the Merger Date by the Secretary will not be made until (i) the Company has received consent for the Rail Merger from the Independent Shareholders; (ii) KCRC has received consent from the KCRC Bondholders; and (iii) the US CBL Assumption Agreements have been entered into.

If the Merger Date does not occur on or before 1 June 2008 and the Company, KCRC and the Government have not, on or before that date, agreed otherwise, then each of the Government and the Company has the right to terminate the Transaction Agreements.

The Rail Merger Ordinance provides, amongst other things, for the following:

- to change the Chinese name of the Company from "地鐵有限公司" to "香港鐵路有限公司";
- to include in the franchise granted to the Company under the MTR Ordinance the rights to construct and operate certain railways in addition to the construction of any extension to the MTRC Railway and the operation of the MTRC Railway (and its extensions);
- to provide for the vesting of certain rights and liabilities of KCRC in the Company;
- to provide for the regulation (other than in relation to any fare payable for using any railway service or bus service operated by the Company) under the MTR Ordinance of the operation by the Company of certain railways and certain bus services in addition to the MTRC Railway, including all aspects of safety concerning those railways;

- to enable KCRC to grant rights to the Company to have access to, use or possess any railway and other property of KCRC for the purposes of the operation of the railway;
- to enable KCRC to dispose of property in connection with the grant of those rights; and
- to make provision for connected purposes of the above.

## 8. CURRENT BUSINESS OF THE COMPANY

The Company was incorporated on 30 June 2000. It succeeded the Mass Transit Railway Corporation which was established in 1975 as a statutory corporation which was wholly-owned by the Government. The principal business of the Company is to operate the MTRC Railway. Following an initial public offering, the MTRC Shares were listed on the Stock Exchange on 5 October 2000.

The Company currently operates a railway network which has a 91.0 km route with 53 stations. With a weekday daily patronage of over 2.5 million passengers, the system is one of the most intensively utilised railway systems in the world.

Besides railway operations, the Company is also involved in the development of key residential and commercial property projects above and adjacent to existing stations and along new line extensions as well as many other commercial activities associated with the railway including rental of retail, ATM banking facilities and advertising space, and the provision of infrastructure for personal telecommunication services. It also provides various consultancy services to organisations worldwide.

The operations of the Company and the MTRC Railway are currently subject to the terms and conditions contained, amongst other things, in the MTR Ordinance and the Existing Operating Agreement.

Further details of the business activities of the Company are contained in the section headed "Information on the Business of the Company".

## 9. CURRENT BUSINESS OF KCRC

The first section of the Kowloon-Canton Railway opened in 1910. KCRC was established as a statutory corporation pursuant to the KCRC Ordinance on 24 December 1982 for an unlimited duration to operate the Hong Kong section of the Kowloon-Canton Railway.

KCRC currently provides three domestic passenger rail services: East Rail (including MOS Rail, and LMCSL which opened in August 2007), West Rail and Light Rail. East Rail, a suburban mass transit service, is Hong Kong's primary north-south transportation artery. It operates between East Tsim Sha Tsui and the Mainland boundary at Lo Wu and Lok Ma Chau. MOS Rail provides an interchange with the main East Rail alignment at Tai Wai and runs to Ma On Shan. West Rail is a mass transit service running between the North-West New Territories and Kowloon. It links Hong Kong's growing new towns and the urban centre. Light Rail, a partially road-based system, is the major mode of transport within the North-west New Territories and also provides a feeder service for West Rail. TSA Buses support the West Rail and Light Rail networks by providing feeder services.

In addition to its core territorial rail and bus services, KCRC also operates intercity passenger and freight services via East Rail to and from various locations in the Mainland.

KCRC has been involved in the development of properties along its railway lines with established property developers since 1985. KCRC has sold most property developments, but retains a certain amount for operational purposes and for leasing to tenants. KCRC lets commercial premises in stations, commercial offices and shopping centres as well as residential units. At the end of 2006, KCRC's occupancy rate was 94% in relation to its commercial premises, 100% in relation to its office premises and 73% in relation to its residential units.

KCRC also derives income from duty free business, Newsline Express and various sources of advertising promotional activities at its properties and from various telecommunications services such as optical fibre leasing and the provision of mobile phone coverage in stations, tunnels and along railway tracks.

The operations of KCRC are currently subject to the terms and conditions of, amongst other things, the KCRC Ordinance and associated regulations.

The net profit attributable to KCRC's total assets, as shown in its annual report for the year ended 31 December 2005 was HK$317 million and for the year ended 31 December 2006 was HK$278 million. The book value of KCRC's total net assets as at 31 December 2006 was HK$59,933 million.

Shareholders should note that the Rail Merger does not involve the acquisition of a significant portion of KCRC's tangible railway assets.

Further details on the business activities of KCRC are contained in the section headed "Information on the Business of KCRC".

## 10. THE COMPANY POST-RAIL MERGER AND FUTURE PLANS

As further detailed in the paragraph headed "Reasons for and Benefits of the Rail Merger" in this section of this Circular, the Directors believe that the Rail Merger will further enhance the Company's primary aims and strategy objectives. Included in those aims and objectives is the Company's commitment to continue to:

- provide opportunities for employees to grow and prosper with the Company;
- enhance the value of the Company for the Shareholders;
- provide excellent value to its customers, enhancing their quality of life, and contributing to development of the communities in which the Company operates;
- develop the Integrated Railway as the backbone of public transport in Hong Kong; and
- grow in the Mainland and capture opportunities in Europe by building on the Company's core competencies.

The Rail Merger, if approved by the Independent Shareholders and subject to the other Conditions, will have effect from the Merger Date. One of the principal aims of the Company is to ensure that the integration of the MTRC Services and KCRC System is effected as quickly and as efficiently as possible. In order to effect this integration, both the public facing operations and the administrative operations will, to the extent reasonably practical, be combined. In addition to assisting efficient integration, the expected creation of synergies between the two systems is expected to provide for cost savings in a number of areas which will enable the Company to make the fare reductions on the Merger Date.

### Rail Operations

With effect from the Merger Date, the MTRC Services and the KCRC System will be operated as a single combined system. A number of the anticipated synergies may take time to create but it is expected that all significant aspects of the integration will be implemented within three years after the Merger Date.

As discussed in the paragraph headed "Background to the Rail Merger" in this section of this Circular, one of the key parameters for the Government, when considering the Rail Merger, was to ensure that the Rail Merger creates a seamless integration of travel between the MTRC Railway and KCRC Railway. This will require, amongst other things, the removal of ticketing barriers at MTR and KCR interchange stations allowing passengers to travel from the KCRC Railway to the MTRC Railway (and vice versa) without the need to pass through intermediate ticket barriers or the need to pay a second boarding charge. The stations which will be affected by this process are Kowloon Tong, Nam Cheong and Mei Foo. The removal of such barriers is planned to be completed within 12 months after the Merger Date.

In addition to seamless interchanges between the two systems, the MTRC Services and KCRC Services will be aligned and integrated as far as practicable. The integration will include unified branding logos, signage and passenger information across the network and a new set of single uniform for staff and the combined operating teams at interchange stations. The existing four operation control centres will be consolidated into one integrated control centre at Tsing Yi in the long term. The IT Enterprise Resource Planning (ERP) systems for finance, HR and asset management is planned to be integrated within 12 months after the Merger Date.

The Company will continue to progress its network expansion projects, including existing projects relating to the construction of the Tseung Kwan O Station South and the Hong Kong Station's extended overrun tunnels. As discussed in the section of this Circular headed "Information on the Business of the Company", the Company also will continue to progress the design of the West Island Line and its on-going discussions with Government relating to extensions of the South Island Line, the North Island Link and the Kwun Tong Line Extension. In addition to the expansion of the MTRC Railway, the Company will also benefit from the expansion of the KCRC Railway. The KSL will, upon its completion, expand KCRC Railway and will become subject to the Service Concession (and there shall be no increase in the Fixed Annual Payments as a result thereof). In addition, as discussed in the paragraph headed "Northern Link and Express Rail Link" in the section headed "Information on the Business of KCRC", proposals have been submitted to the Government in respect of the Northern Link and the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link.

In July 2005, the Company and KCRC jointly submitted to the Government a project proposal on the SCL scheme and, according to the Transport and Housing Bureau, the SCL remains a committed project for implementation. As discussed in the paragraph headed "Shatin to Central Link" in the section headed "Information on the Business of KCRC", the Transport and Housing Bureau has stated that it would further discuss with the railway corporations on the funding and implementation details and would consider whether to adopt the ownership approach or the concession approach for implementing the SCL. Furthermore, the Administration has promised to make a decision on the way forward for the SCL within six months after the completion of the legislative process for the Rail Merger.

The Octopus system will not be affected by the Rail Merger. At present, KCRC and the Company each have significant interests in the company which operates the Octopus system. The KCRC interests in Octopus form part of the Excluded Assets.

With effect from the Merger Date, as an Integrated Railway, both the MTRC Railway and the KCRC Railway will be subject to a single regulatory regime. The operations of the Integrated Railway will be regulated by the MTR Ordinance, the MTR Regulations and the Operating Agreement. The KCRC Regulations and By-laws will be suspended for the duration of the Concession Period. Passengers travelling on the Integrated Railway (other than on Light Rail) will be subject to the MTR By-Laws. Light Rail will also be subject to the terms of the MTR Ordinance and the Operating Agreement and passengers travelling on Light Rail will be subject to the terms of the Mass Transit Railway (North-west Railway) By-Law.

**Property**

The existing departments under the Property Division of the Company will continue to be responsible for the Company's property developments, investment properties, property management and all other property related business and service in both Hong Kong and the Mainland.

With effect from the Merger Date, the Company will acquire from KCRC the economic benefits of certain property development rights, investment properties and property management rights. The enlarged land bank will enable the Company to build more high quality communities with convenient living and commercial environment. An incentive scheme for West Rail property development sites will also apply to the Company. The employees from the respective property departments of KCRC will be transferred to the Company. As noted above the Company aims to create synergies between the existing departments of the Company and KCRC. This will involve the integration of the property teams of KCRC and the Company and property related administrative operations such as the streamlining of computer systems, record retention, database keeping, invoicing and tendering processes.

As discussed in the paragraph headed "Merger Framework Agreement" in the Appendix to this Circular headed "Transaction Agreements", the Merger Framework Agreement contains a mechanism pursuant to which the Government and the Company shall conduct an annual exercise to discuss and draw up a rolling programme on the level of flat production arising from tenders for railway property development by the Company for the three succeeding years (the first year in respect of which shall be binding on the Company). The first such exercise shall be initiated by the Government on or around the first September after the Merger Date. This formalised mechanism reflects the informal arrangements under which the Company and the Government currently operate so that the Government may monitor the overall housing supply situation in Hong Kong.

**Other Activities**

The Company will seek to seize the opportunities provided by its stronger market position arising from the Rail Merger, both with customers and suppliers, and by the application of best practice to extract best value from the Company's businesses and assets. The initiatives will include expanding the MTR Club concept, extending the bandwidth business as well as the cross-selling of roof top sites for the telecommunications business.

The Company proposes to leverage its and KCRC's expertise in assessing and implementing overseas opportunities. The Company will combine its experience in railway and property projects in the Mainland and overseas markets (including in Europe) with KCRC's knowledge in dealing with Mainland authorities and KCRC's experience in suburban rail, Light Rail, intercity, freight and bus operations. The Company, with a bigger pool of talented employees, will be able to offer a wider range of rail operations expertise to potential international and Mainland customers and joint venture partners.

The Company will carry out a number of administrative activities for and on behalf of KCRC after the Merger Date on an outsourcing basis (further details of which are contained in the paragraph headed "KCRC Post-Rail Merger" in this section of this Circular).

**The Board, the Executive Directorate and deputy Directors**

With effect from the Merger Date, the members of the Board, the Executive Directorate and the deputy Directors of the Company will be as set out below. Government may also, at its sole discretion, determine before the Merger Date the number of additional non-executive directors (if any) to be appointed to the Board on the Merger Date.

**Members of the Board**

| | |
|---|---|
| Dr. Raymond Ch'ien Kuo-fung | Non-Executive Chairman |
| Chow Chung-kong | Chief Executive Officer |
| Professor Chan Ka-keung, Ceajer (Secretary for Financial Services and the Treasury) | Non-executive Director |
| Secretary for Transport and Housing (Eva Cheng) | Non-executive Director and "additional director" appointed under section 8 of the MTR Ordinance |
| Commissioner for Transport (Alan Wong Chi-kong) | Non-executive Director and "additional director" appointed under section 8 of the MTR Ordinance |
| Professor Cheung Yau-kai | Independent non-executive Director |
| David Gordon Eldon | Independent non-executive Director |
| Christine Fang Meng-sang | Independent non-executive Director |
| Edward Ho Sing-tin | Independent non-executive Director |
| Lo Chung-hing | Independent non-executive Director |
| T. Brian Stevenson | Independent non-executive Director |

**Members of the Executive Directorate and Deputy Directors**

| | |
|---|---|
| Chow Chung-kong | Chief Executive Officer |
| Russell John Black | Project Director |
| William Chan Fu-keung | Human Resources Director |
| Thomas Ho Hang-kwong | Property Director |
| Lincoln Leong Kwok-kuen | Finance Director |
| Francois Lung Ka-kui | China & International Business Director |
| Andrew McCusker | Operations Director |
| Leonard Bryan Turk | Legal Director and Secretary |

**Deputy Directors**

| | |
|---|---|
| Dr. Lee Kang-kuen | Deputy Project Director |
| Li Yun-tai | Deputy Operations Director |
| David Fleming | Deputy Legal Director |

Further details on each of the above members of the Board, the Executive Directorate and the deputy Directors are contained in the paragraph headed "Details of Directors and Senior Managers" in the Appendix to this Circular headed "General Information".

### Employees

The Company's vision with regards to its and KCRC's employees after the Rail Merger is towards "One Company, One Team". The aim is to encourage and facilitate staff to work as one team as quickly as possible and to assume their roles after the Rail Merger with the least disruption. The Company proposes to make a number of arrangements with regards to staffing synergies and the implementation of the "One Company, One Team" vision.

The majority of Frontline Staff will remain in their current positions. Where placement to other positions is required, it will be made on a voluntary basis as far as possible. With the implementation of staffing synergies there will be certain non-Frontline Staff who need to go through a selection process. Those who will need to go through a selection process will be considered automatically for positions that are relevant to their current functions. To provide an additional option, a voluntary separation scheme will be provided to all eligible non-Frontline Staff employed on ongoing terms and an alternative arrangement will be provided to all eligible non-Frontline Staff employed on contract terms.

## 11. KCRC POST-RAIL MERGER

With effect from the Merger Date, KCRC will no longer be the operator of any railway system in Hong Kong. As further detailed in the MFA and the SCA, KCRC will retain the legal title to the Concession Property as at the Merger Date but will grant the Service Concession to the Company to operate and maintain it for the Concession Period.

After the Merger Date, KCRC will continue to have certain of its own limited back-office financial and administrative requirements. For a period of two years, KCRC will outsource certain financial and administrative functions to the Company. KCRC will retain an executive board and most staff required by KCRC will be outsourced from the Company. The terms of the outsourcing arrangements are set out in the Outsourcing Agreement which is summarised in the paragraph headed "Outsourcing Agreement" in the Appendix to this Circular headed "Transaction Agreements".

## 12. SOURCE OF FUNDING FOR THE RAIL MERGER

The Company will be funding the Initial Payments (amounting to HK$12.04 billion) from a combination of internal financing resources, drawings from existing undrawn committed banking facilities and new debt financing to be raised. It is expected that the Fixed Annual Payments and the Variable Annual Payments will be funded from internal resources and/or debt financing.

## 13. FINANCIAL EFFECTS ON THE COMPANY OF THE RAIL MERGER

### Turnover and earnings

The Company's turnover for the financial year ended 31 December 2006 was HK$9,541 million.

The Directors expect that the Company's turnover and earnings can be significantly improved over coming years through a combination of increased passenger numbers, property development, railway expansion into new catchment areas and savings resulting from efficiencies associated with running an integrated railway service.

As part of the Rail Merger, the Company will be required to pay the Upfront Payment. This Upfront Payment, net of the consideration for the Purchased Rail Assets, will be capitalised as a service concession asset under Hong Kong (IFRIC) 12 "Service Concession Arrangements" and amortised over the term of the Concession Period.

Additionally, on the Merger Date the Company is required to make a further payment of HK$7.79 billion for the Property Package. The acquisition of the investment properties comprised in the Property Package will be accounted for at cost to the Company. At each reporting balance sheet date, the investment properties comprised in the Property Package will be carried at fair value as determined by independent professional qualified valuers. Hong Kong Accounting Standard No. 40 "Investment Properties" requires changes in the fair values of investment properties to be recognised as profit or loss in the period in which they arise. The amounts relating to property management rights comprised in the Property Package will be amortised over the first two years of the relevant management period. The amounts relating to property development rights comprised in the Property Package will be initially capitalised and offset against any future revenue generated from these property developments in determining the resulting property development profits that will be recognised in the profit and loss account.

Further, during the Concession Period, the Company will be required to pay Fixed Annual Payments of HK$750 million to KCRC. The net present value of such committed payments will be capitalised as a concession asset and amortised over the term of the Service Concession. The implied interest thereon, calculated at the estimated incremental cost of borrowing for the Company for the long-term, will be charged to the profit and loss account as interest and finance charge.

Except in respect of the first 36 months after the Merger Date, the Company will be required to pay Variable Annual Payments to KCRC as part of the consideration for the right to use and access the Concession Property for the operation of the Service Concession. As such, the Company is expected to pay to KCRC a designated percentage of the revenue generated from the operation of the KCRC system (further details on the payment terms of the Rail Merger are contained in the paragraph headed "The Rail Merger Package and Consideration" in this section of this Circular).

The financial effects of the Rail Merger, based on historic figures are shown in the Pro-forma Financial Statements which are contained in the section of this Circular headed "Financial Information of the Enlarged Group".

Due to the contingent nature of the Variable Annual Payments, such payments would be recorded in the profit and loss account in the period in which such payments are incurred.

**Assets and liabilities**

As of 30 June 2007 the Company's total assets amounted to HK$123,034 million and its total liabilities amounted to HK$42,737 million.

Upon completion of the Rail Merger, the total assets of the Company will be increased by (i) the accounting for the Upfront Payment and the payment for the Property Package, (ii) the accounting for the Fixed Annual Payments under the Service Concession, (iii) mandatory payment receivable in respect of the sites subject to the property development rights, (iv) the value of investment properties in the Property Package based on JLL's valuation over the cost to the Company for the acquisition of such properties.

Upon completion of the Rail Merger, the total liabilities of the Company will be increased by (i) the amount of bank borrowing and debt financing used by the Company to finance the Rail Merger, (ii) the liability accounting for the Fixed Annual Payments under the Service Concession, (iii) the amounts relating to certain enabling works on property development sites which shall be reimbursed to KCRC after collection from relevant developers, (iv) the amounts of liabilities assumed or transferred from KCRC on the Merger Date and (v) additional deferred tax liabilities with respect to the increase in value of investment properties acquired over cost of acquisition.

**Working Capital**

The Directors are of the opinion that, taking into account the internal resources and the unutilised financing facilities currently available to the Group and new bank loan financings to be raised, the Group will, following completion of the proposed Rail Merger, have sufficient working capital to satisfy its present requirements for the following twelve months from the anticipated Merger Date.

**Credit Ratings**

After the passage of the Rail Merger Ordinance on 8 June 2007, Rating & Investment Inc. announced on 4 July 2007 that it had affirmed the Company's foreign currency issuer and Hong Kong dollar issuer ratings at AA with a stable rating outlook citing the content of the Rail Merger as being reasonable to the Company.

On 16 July 2007, Standard & Poor's announced that it had affirmed the Company's foreign currency issuer and senior unsecured debt ratings at AA with a stable outlook, after taking into account the potential merger between the operations of the Company and KCRC and assuming the terms set out in the Memorandum of Understanding would be reflected in the final terms and conditions of the Rail Merger.

On 16 July 2007, Moody's also affirmed the Company's current ratings of Aa3 and announced that it continued to review these ratings for possible upgrade following LegCo's approval of the primary legislation for the Rail Merger.

On 26 July 2007, Moody's upgraded the Company's foreign currency issuer and senior unsecured debt ratings to Aa2 from Aa3 with a stable rating outlook following its decision to upgrade the Government's ratings to Aa2.

Also on 26 July 2007, Standard & Poor's announced it had revised its outlook on the Company's local and foreign currency long-term credit ratings to positive from stable at the same time reaffirming the Company's long-term credit ratings at AA following a corresponding revision to the outlook on the Government.

**Directors' Remuneration**

It is not currently proposed that the aggregate of remuneration payable to, and benefits in kind received by, the members of the Board and the Executive Directorate will change in consequence of the Rail Merger. However, it is expected that the Remuneration Committee of the Company will conduct a review of the remuneration received by the members of the Board and the Executive Directorate if the Rail Merger is approved by the Independent Shareholders. Separately, there may be increases if additional non-executive Directors are appointed to the Board.

## 14. IMPLICATIONS UNDER THE LISTING RULES

**Very Substantial Acquisition**

The Rail Merger and the entering into of the Transaction Agreements together constitute a very substantial acquisition for the Company under Chapter 14 of the Listing Rules and is, amongst other things, subject to the approval of the Shareholders.

**Connected Transactions**

As at the Latest Practicable Date, the Government is a substantial shareholder of the Company (holding approximately 76.67% of the MTRC Shares) and the sole shareholder of KCRC (making KCRC an "associate" of the Government for the purposes of the Listing Rules). Therefore, the Rail Merger and the entering into of the Transaction Agreements also constitute connected transactions pursuant to Chapter 14A of the Listing Rules. As the Rail Merger and the Transaction Agreements fall outside the *de minimis* thresholds set out in Rules 14A.31(2) and 14A.32 of the Listing Rules, they are subject to the approval of the Independent Shareholders of the Company.

Any connected person with a material interest in a connected transaction and any Shareholder (together with its associates) with a material interest in the connected transaction, is also required to abstain from voting on resolutions approving the transaction.

Accordingly, the Government and its associates (not being Independent Shareholders) will be required to abstain from voting on the EGM Resolution as connected persons with a material interest in the Rail Merger and the Transaction Agreements.

***Waivers and Exemptions***

The Stock Exchange has granted certain exemptions and/or waivers from strict compliance with the Listing Rules with respect to (i) continuing connected transactions of the Company, (ii) the sections of this Circular headed "Accountants' Report" and Pro-forma Information of the Enlarged Group, respectively (iii) the section of this Circular headed "Property Valuation Report" and (iv) other property valuation reports obtained by the Company. Details of the waivers/exemptions granted and the reasons therefore are as follows:

*Connected Transactions and Continuing Connected Transactions*

The Company and its subsidiaries have entered into, and will as a result of and after the Rail Merger, continue to enter into a range of transactions with the Government and its associates.

Given the unique nature of the Company, its business and its on-going dealings with the Government and its associates, at the time of the Company's initial public offering and listing on the Stock Exchange, the Stock Exchange granted a waiver to the Company from strict compliance with the requirements of the Listing Rules relating to connected transactions (subject to certain conditions) which would otherwise apply to certain transactions with the Government and its associates, including KCRC. That waiver was renewed and updated in 2004 subject to the Company not being permitted to rely on it for the purposes of the Rail Merger. As a result, as noted above, the Rail Merger and the entering into of the Transaction Agreements together are subject to the approval of the Independent Shareholders.

As a result of the Rail Merger, the Company will, with effect from the Merger Date, be a party to a number of additional continuing connected transactions. These additional continuing connected transactions are not currently covered by the existing waiver because, as stated above, the existing waiver contains a condition that the Company is not permitted to rely on it for the purposes of the Rail Merger. Had it not been for this condition, the existing waiver (which pre-Rail Merger applies to, and covers, contracts entered into by the Company in respect of the MTRC Railway) would have applied to, and covered, the Rail Merger and the Transaction Agreements and the Company would not have needed to make an application to the Stock Exchange for a new waiver (which will apply to, and cover, contracts entered into by the Company post-Rail Merger in respect of the Integrated Railway) from strict compliance with Chapter 14A of the Listing Rules (further details of the new waiver are set out below). Additional continuing connected transactions will arise after the Rail Merger with respect to the obligations of the Company under:

- the Merger Framework Agreement, other than those arrangements which will be fully implemented by the Merger Date;
- the Operating Agreement, including the requirement to operate the Integrated Railway in accordance with the Operating Agreement during the period of the Franchise as it relates to the Integrated Railway;
- the Service Concession Agreement, including the requirement to make the Concession Payments during the Concession Period;
- the KSL Project Management Agreement, which will continue until the construction of the Kowloon-Southern Link has been completed;
- the West Rail Agency Agreement, which will continue in force until the West Rail property developments have each been completed;
- the US CBL Assumption Agreements and the US CBL Allocation Agreement, which are each expected to last for the duration of the underlying CBLs;
- the Outsourcing Agreement, which will continue for a period of two years from the Merger Date;
- those existing contracts between KCRC and the Government (and/or its associates) which are vested by law in the Company; and
- the Property Package Agreements, which will contain the terms on which the relevant land and land interests will be held on an on-going basis.

Given the unique nature of the Company, its business and its on-going dealings with the Government and its associates, the Company has made an application to the Stock Exchange for a waiver to be granted from strict compliance with Chapter 14A of the Listing Rules.

Recognising these unique circumstances, the Stock Exchange has agreed to treat the connected transactions between the Company and the Government (and/or their respective associates) arising as a result of the Rail Merger as follows:

- continuing connected transactions arising in connection with the Rail Merger and the Transaction Documents, would be subject to a waiver from the strict application of the requirements of Chapter 14A of the Listing Rules. Such continuing transactions relate to the obligations of the Company under:
    - the Merger Framework Agreement, other than those arrangements which will be fully implemented by the Merger Date;
    - the Operating Agreement, including the requirement to operate the Integrated Railway in accordance with the Operating Agreement during the period of the Franchise as it relates to the Integrated Railway;
    - the Service Concession Agreement, including the requirement to make the Concession Payments during the Concession Period;
    - the KSL Project Management Agreement, which will continue until the construction of the Kowloon-Southern Link has been completed;

  - the West Rail Agency Agreement, which will continue in force until the West Rail property developments have each been completed;
  - the US CBL Assumption Agreements and the US CBL Allocation Agreement, which are each expected to last for the duration of the underlying CBLs;
  - the Outsourcing Agreement, which will continue for a period of two years from the Merger Date;
  - those existing contracts between KCRC and the Government (and/or its associates) which are vested by law in the Company; and
  - the Property Package Agreements, which will contain the terms on which the relevant land and land interests will be held on an on-going basis; and

- certain of the above continuing connected transactions would be subject to new waiver conditions imposed by the Stock Exchange which would be substantially the same as the relevant conditions of the existing waiver as they apply to continuing connected transactions.

Further details of the existing and new waivers relating to connected transactions and continuing connected transactions between the Company and Government (and its associates) are contained in the paragraph headed "Connected Transactions and Continuing Connected Transactions" in the section of this Circular headed "Relationship with Government".

*Accountants' Report*

Rule 14.69(4)(a) and Chapter 4 of the Listing Rules requires an accountants' report to be prepared on the businesses which are the subject of the Rail Merger.

The terms of the Rail Merger effectively involve an acquisition (whether by way of transfer of legal or beneficial title, service concession or licence) of those assets, or rights thereto, and liabilities which are currently required by KCRC to operate and maintain the KCRC business (rail, property and otherwise). Under the terms of the Service Concession Agreement, the tangible assets that form part of the current KCRC railway network are not acquired by the Company but are subject to a service concession arrangement whereby the Company will have the right to access, use and operate these assets for a specified term. Legal title to these assets remains with KCRC and they will remain recognised on the balance sheet of KCRC, however, the operating results generated by such assets over the concession period will effectively be acquired by the Company.

Given the complexity, nature and commercial substance of the proposed arrangements of the Rail Merger, the Directors consider that the inclusion of the published financial statements of KCRC for each of the three years ended 31 December 2004, 2005 and 2006 and the audited financial statement for the six months ended 30 June 2007, would present the most meaningful and comprehensive information to the Shareholders in understanding the business operations of KCRC that will be subject to the terms of the Rail Merger by presenting the revenue generated and expenses incurred, together with the assets employed and liabilities incurred of the business operations of KCRC during the three years ended 31 December 2004, 2005 and 2006 and six months ended 30 June 2007.

Accordingly, the Stock Exchange has granted to the Company a waiver from strict compliance with Listing Rule 14.69(4)(a)(i) which provides that the accountants' report on KCRC contained in this Circular include the following information:

(i) The published annual financial statements of KCRC and its subsidiaries ("**KCRC Group**") for each of the three years ended 31 December 2004, 2005 and 2006 and the audited accounts for the six months ended 30 June 2007.

(ii) Additional financial information including a reconciliation table and narrative description by way of an explanatory note in the accountants' report to explain the impact of the proposed arrangement on the financial results and operating cashflow of the KCRC Group for the year ended 31 December 2006 and six months ended 30 June 2007 and the financial position of the KCRC Group as at 30 June 2007. The narrative descriptions and numeric tables would also explain how the figures would be translated to the pro-forma financial information set out in the Circular.

(iii) The report of the reporting accountants would set out the basis of preparation of the accountants' report, the financial information of KCRC Group comprising the consolidated income statement, the consolidated balance sheet, the consolidated statement of changes in equity, the consolidated cash flow statement, and the explanatory notes (including the additional financial information of KCRC referred to in (ii) above) thereon and an opinion that the financial information gives a true and fair view of the KCRC Group's consolidated results and cash flows for the three years ended 31 December 2004, 2005 and 2006 and the six months ended 30 June 2007 and of the state of affairs of the KCRC Group as at 31 December 2004, 2005, 2006, and 30 June 2007.

*Property Valuation Report*

Under Listing Rule 5.01, the Company is required to include in this Circular a valuation report with respect to all the Enlarged Group's interests in land and buildings. Listing Rule 5.06(1) requires certain particulars to be included in that valuation report. The Directors believe that:

- no meaningful valuation figures could be determined for the land and property used in connection with the operation and maintenance of the MTRC Railway and the KCRC Railway (the "**Railway Properties**") and that any valuation figures that may be arrived at by applying normal valuation methodologies would be artificial, particularly given the legal restrictions relating to the use and disposal of Railway Properties; and
- there are commercial sensitivities in relation to the disclosure of detailed valuation figures for (i) properties held for disposal (ii) development properties where development packages have been awarded and (iii) development properties where development packages have not yet been awarded.

Accordingly, the Company has applied to the Stock Exchange for waivers from strict compliance with the requirements under Listing Rule 5.06 in the following terms:

- the Company's interests in land and buildings and KCRC's interests in land and buildings will be valued and presented separately;
- in respect of the Railway Properties, that they are not required to be valued in the Property Valuation Report, contained in the Appendix to this Circular headed "Property Valuation Report on the Enlarged Group";
- in respect of properties which are held for disposal, that they are valued in the Property Valuation Report, contained in the Appendix to this Circular headed "Property Valuation Report on the Enlarged Group", on a station-by-station basis if there is more than one development per station; or if there is only a single development at a station then the valuations of all such developments shall be valued together and presented as a single figure. The percentage interests attributable to the Company have been stated as a range of percentages on a station-by-station basis or on an aggregated basis as appropriate;
- in respect of the development properties where packages have been awarded, that they are valued in the Property Valuation Report, contained in the Appendix to this Circular headed "Property Valuation Report on the Enlarged Group", on a station-by-station basis if there is more than one property tender package for each station; or if there is only one property tender package per station then the valuations of all such developments shall be presented as an aggregate sum. The range of the profit sharing ratios for the developments has been stated for the Company's properties and a range of the profit sharing ratios for the developments have been stated for KCRC's properties; and
- in respect of the development properties where development packages have not yet been awarded, that they are valued in the Property Valuation Report, contained in the Appendix to this Circular headed "Property Valuation Report on the Enlarged Group", together and presented as a single figure. A reasonable assumption has been made by the Company of the profit sharing ratio for each development. A range of these assumed ratios has been stated for the Company's properties and a range of profit sharing ratios have been stated for KCRC's properties,

in each case for the reasons set out above.

The Stock Exchange has granted a waiver from strict compliance with Listing Rule 5.06 in the terms applied for and for the reasons set out above.

*Other Property Valuation Reports*

Under Listing Rule 5.09, and because this Circular contains a property valuation report of the Company's interest in land and buildings, the Company is required to also include in this Circular any other valuation reports regarding its property interests which it has obtained within three months before the issue date of the Circular.

For the purposes of its interim accounts, the Company annually obtains a valuation report in relation to its property interests ("**Interim Property Valuation Report**"). As a result of the requirements of Listing Rule 5.09 and the date of issue of Interim Property Valuation Report for 2007, the Company would be required to include the Interim Property Valuation Report for 2007 in this Circular.

Interim Property Valuation Reports are prepared for the Company solely for the purpose of its preparation of interim accounts, in particular the valuations contained therein are required for the balance sheet and the profit and loss account. Such reports are not prepared for the purpose of wide 'dissemination' as part of shareholder circulars. The Company has engaged two different valuers so that the independence of JLL preparing the property valuation report for inclusion in this Circular ("**JLL's Report**") is maintained (strictly in accordance with the Listing Rules and the Hong Kong Institute of Surveyors Valuation Standards on Properties).

Although the same standards are applied to the preparation of each valuation report, the scope of the reports is quite different. JLL's Report covers the Company's and KCRC's interests in land and buildings. There is no information in the Interim Property Valuation Report for 2007 relating to KCRC's properties. The Interim Property Valuation Report is a valuation of the Company's investment properties, owner-occupied properties and properties held for sale only. The Company therefore believes that the inclusion of the Interim Property Valuation Report would not provide any material information to Shareholders. In this regard the Company applied to the Stock Exchange for a waiver from the strict application of Listing Rule 5.09.

The Stock Exchange granted the Company a waiver from strict compliance with Listing Rule 5.09 subject to the Company making the Interim Property Valuation Report for 2007 (which comprises 19 pages) available for review on the Stock Exchange's website (www.hkex.com.hk) from the date of issue of this Circular.

**Independent Board Committee**

In accordance with Listing Rule 13.39(6)(a), the Company has established the Independent Board Committee to advise the Independent Shareholders as to whether the terms of the Rail Merger and the Transaction Agreements are fair and reasonable and in the interests of the Company and the Shareholders (including the Independent Shareholders) as a whole and to advise the Independent Shareholders on how to vote with respect to the EGM Resolution, taking into account the recommendations of the Independent Financial Adviser.

**Independent Financial Adviser**

In accordance with Listing Rule 13.39(6)(b), Merrill Lynch (Asia Pacific) Limited has been appointed as Independent Financial Adviser to make recommendations to the Independent Board Committee and the Independent Shareholders as to whether the terms of the Rail Merger and the Transaction Agreements are fair and reasonable and whether the Rail Merger and the Transaction Agreements are in the interests of the Company and the Shareholders (including the Independent Shareholders) as a whole and to advise the Independent Shareholders on how to vote with respect to the EGM Resolution.

## 15. BOARD PROCESS FOR CONSIDERING THE RAIL MERGER

As a matter of good corporate governance and in accordance with the Listing Rules, the Board established and has maintained a framework for its decision making processes in relation to the Rail Merger, which, amongst other things, seeks to protect the interests of the Independent Shareholders.

Each relevant Director disclosed and gave notice of his/her respective interests in the Rail Merger. Furthermore, at each meeting of the Board at which the Rail Merger was considered, members who had a conflict of interest did not attend for the relevant part of that meeting at which the Rail Merger was discussed. Specifically, at certain special meetings of the Board, the then Secretary for the Environment, Transport and Works and Mr. Frederick Ma Si-hang (the Secretary for Financial Services and the Treasury), were invited to attend to express the Government's views on the Rail Merger. Members who had conflicts of interest (including the then Secretary for Environment, Transport and Works and Mr. Frederick Ma Si-hang (the then Secretary for Financial Services and the Treasury) and the Commissioner) left such special meetings before the other members of the Board (not having conflicts of interest) discussed the issues involved.

Regular updates on other matters relating to the Rail Merger (including progress of the LegCo Bills Committee meetings and other in-house integration activities such as staff briefing sessions and establishment of new committees) were provided by relevant members of the Executive Directorate at Board meetings.

As stated in the paragraph of this letter headed "Independent Board Committee", the Independent Board Committee has been established to advise the Independent Shareholders. When establishing the Independent Board Committee the Company ensured that its members comprised only independent non-executive Directors, none of whom having an interest in the Rail Merger. The Independent Board Committee, in giving its advice, has acted at all times independently and has taken into account the recommendations of the Independent Financial Adviser.

As stated in the paragraph of this letter headed "Independent Financial Adviser", the Independent Financial Adviser has been appointed to make recommendations and to advise the Independent Board Committee and the Independent Shareholders. The Independent Board Committee was consulted in the preparation of the initial list of 13 potential independent financial advisers. From this list, the Independent Board Committee, acting independently, created a shortlist of four independent financial advisers, each of which was asked to submit a more detailed proposal in relation to its appointment as independent financial adviser. After a final selection process, which was carried out by the Independent Board Committee, Merrill Lynch (Asia Pacific) Limited was appointed as the Independent Financial Adviser.

The Independent Financial Adviser, in making its recommendations and in giving its advice, has also acted at all times independently and without influence from the Company.

## 16. MERGER EGM, SUSPENSION OF DEALINGS AND CLOSURE OF THE REGISTER OF MEMBERS

The Company has convened the Merger EGM for 9 October 2007 to consider, and if thought fit to approve, the terms of the Rail Merger and the Transaction Agreements. Further details of the Merger EGM and the EGM Resolution to be considered at the meeting are contained in the "Notice of Extraordinary General Meeting" set out on pages N-1 to N-2 of this Circular.

The Company considers that the results of the voting by the Independent Shareholders with respect to the EGM Resolution, will be 'price sensitive information' for the purposes of Rule 13.09 of the Listing Rules. As a result the Company will request that the Stock Exchange suspends the dealing of MTRC Shares on Tuesday, 9 October 2007 until 9:30 a.m. on Wednesday, 10 October 2007.

**For the purpose of determining entitlements to attend and vote at the Merger EGM, the register of members of the Company will be closed from 9:00 a.m. on 8 October 2007 until 4:30 p.m. on 9 October 2007.** In order to qualify for attending and voting at the Merger EGM, all completed transfer forms accompanied by the relevant Share certificates must be lodged with the share registrar of the Company, Computershare Hong Kong Investor Services Limited at Rooms 1806-1807, 18th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong, not later than 4:30 p.m. on Friday, 5 October 2007.

Whether or not you are able to attend the Merger EGM, you are requested to complete and return the Proxy Form in accordance with the instructions printed thereon, as soon as possible and in any event not later than 48 hours before the time appointed for the Merger EGM or any adjourned meetings thereof. Completion and return of a Proxy Form will not preclude you from attending and voting in person at the Merger EGM or at any adjourned meetings thereof should you so wish.

## 17. PROCEDURE BY WHICH SHAREHOLDERS MAY DEMAND A POLL

The procedure by which Shareholders may demand a poll at a general meeting of the Company is set out in Article 67 of the Company's Articles of Association which provides as follows:

"A resolution put to the vote at any general meeting will be decided on a show of hands unless a poll is demanded when, or before, the chairman of the meeting declares the result of the show of hands. A poll may be demanded by:

(a) the chairman of the meeting;

(b) at least five shareholders at the meeting (including proxies) who are entitled to vote;

(c) one or more shareholders at the meeting (including proxies) who are (or represent members who are) entitled to vote and who have between them at least ten per cent. of the total votes of all shareholders (including proxies) who have the right to vote at the meeting; or

(d) one or more shareholders (including proxies) who have (or represent members who have) shares which allow them to vote at the meeting and on which the total amount which has been paid up on these shares is at least ten per cent. of the total sum paid up on all shares which give the right to vote at the meeting.

A demand for a poll can be withdrawn if the chairman of the meeting agrees to this.

If no poll is demanded or a demand for a poll is withdrawn, any declaration by the chairman of the meeting of the result of a vote on that resolution by a show of hands will stand as conclusive evidence of the result without proof of the number or proportion of the votes recorded for or against the resolution."

The EGM Resolution will be decided on a poll.

## 18. RECOMMENDATION

Your attention is drawn to the letter from the Independent Board Committee (contained in the section of this Circular headed "Letter from the Independent Board Committee") which contains its advice to the Independent Shareholders as to how to vote at the Merger EGM in relation to the EGM Resolution. Your attention is also drawn to the letter from the Independent Financial Adviser to the Independent Board Committee and the Independent Shareholders (which is contained in the section of this Circular headed "Letter from the Independent Financial Adviser") which contains its recommendations and advice with respect to the terms of the Rail Merger, as contemplated by the Transaction Documents including the principal factors and reasons considered by it in arriving at its recommendations and advice.

The Directors consider the terms of the Rail Merger as contemplated by the Transaction Documents as fair and reasonable and in the interests of the Company and the Shareholders as a whole. The Directors, including the independent non-executive Directors, therefore recommend the Independent Shareholders to vote at the Merger EGM in favour of the EGM Resolution to approve the Rail Merger and the Transaction Agreements.

## 19. ADDITIONAL INFORMATION

Your attention is also drawn to the Appendices of this Circular headed "Financial Information of the Group", "Accountants' Report on KCRC", "Management Discussion and Analysis on KCRC", "Financial Information of the Enlarged Group" and "Property Valuation Report on the Enlarged Group" and the additional information of the Company and other information relating to the Rail Merger set out in this Circular and the other Appendices to it.

By order of the Board
**MTR Corporation Limited**
**Dr. Raymond Ch'ien Kuo-fung**
*Chairman*

*The following is the text of a letter from the Independent Board Committee setting out its advice to the Independent Shareholders in relation to the Rail Merger.*

地鐵公司
MTR Corporation

# MTR CORPORATION LIMITED
## (地 鐵 有 限 公 司)

(Incorporated in Hong Kong with limited liability)

**(Stock Code: 66)**

**The Independent Board Committee**
Edward Ho Sing-tin (*Chairman*)
Professor Cheung Yau-kai
David Gordon Eldon
Christine Fang Meng-sang
Lo Chung-hing
T. Brian Stevenson

*Registered Office*:
MTR Tower
Telford Plaza
Kowloon Bay
Hong Kong

*Principal Office*:
MTR Tower
Telford Plaza
Kowloon Bay
Hong Kong

3 September 2007

**To the Independent Shareholders**

Dear Sir or Madam,

### RAIL MERGER
### (1) CONNECTED TRANSACTIONS
### (2) VERY SUBSTANTIAL ACQUISITION

We refer to the circular of the Company dated 3 September 2007 (the "**Circular**") of which this letter forms part. Terms defined in the Circular have the same meanings herein unless the context otherwise requires.

We have been appointed to form the Independent Board Committee to consider the terms of the Rail Merger as contemplated by the Transaction Documents and to advise the Independent Shareholders whether, in our opinion, such terms are fair and reasonable and in the interests of the Company and the Shareholders (including the Independent Shareholders) as a whole and to advise the Independent Shareholders on how to vote, taking into account the recommendations of the Independent Financial Adviser.

Merrill Lynch (Asia Pacific) Limited has been appointed as Independent Financial Adviser to make recommendations to the Independent Board Committee and the Independent Shareholders as to whether the terms of the Rail Merger as contemplated by the Transaction Documents are fair and reasonable and whether the Rail Merger as contemplated by the Transaction Documents are in the interests of the Company and the Shareholders (including the Independent Shareholders) as a whole, and to advise the Independent Shareholders on how to vote.

We wish to draw your attention to the letter from the Board (included in the section of the Circular headed "Letter from the Board") which contains, *inter alia*, information on the Rail Merger and the Transaction Agreements, and the letter from the Independent Financial Adviser (included in the section of the Circular headed "Letter from the Independent Financial Adviser") which contains its recommendations in respect of the terms of the Rail Merger as contemplated by the Transaction Documents.

Having taken into account the recommendations of the Independent Financial Adviser, we consider that the terms of the Rail Merger and the Transaction Agreements are fair and reasonable and are in the interests of the Company and the Shareholders (including the Independent Shareholders) as a whole. Accordingly, we advise the Independent Shareholders to vote in favour of the EGM Resolution which is to be proposed at the Merger EGM and as is set out in the notice of the Merger EGM (contained on pages N-1 to N-2 of the Circular).

If you are in any doubt as to any aspect of the Circular, or as to the action to be taken, you should consult a licensed securities dealer, bank manager, solicitor, professional accountant or other professional adviser.

Yours faithfully,
for and on behalf of
**The Independent Board Committee**
Edward Ho Sing-tin *(Chairman)*

Merrill Lynch

3 September 2007

The Independent Board Committee and the Independent Shareholders
MTR Corporation Limited
MTR Tower, Telford Plaza
Kowloon Bay, Hong Kong

To the Independent Board Committee and the Independent Shareholders

Dear Sirs and Madams,

## RAIL MERGER — CONNECTED TRANSACTIONS AND VERY SUBSTANTIAL ACQUISITION

### 1. INTRODUCTION

Merrill Lynch (Asia Pacific) Limited ("**Merrill Lynch**") has been appointed by the Company to act as the Independent Financial Adviser to advise the Independent Board Committee and the Independent Shareholders, pursuant to the requirements of the Listing Rules, in respect of the Rail Merger, details of which are set out in the Circular issued by MTRC dated 3 September 2007.

The Rail Merger and the entering into of the Transaction Agreements constitute a "very substantial acquisition" for the Company under Chapter 14 of the Listing Rules and are therefore, amongst other things, subject to the approval of the Independent Shareholders by a simple majority of those voting in person or by proxy. Implementation of the Rail Merger is also subject to, amongst other things, the commencement of the Rail Merger Ordinance. As at the Latest Practicable Date, the Government owned 76.67% of the MTRC Shares and, as such, for the purposes of the Listing Rules the Government is a "connected person" of the Company. KCRC, being wholly-owned by the Government, is also a "connected person" of the Company. As the Government and/or KCRC is a party to the Transaction Agreements, the Rail Merger involves "connected transactions" for the Company under Chapter 14A of the Listing Rules.

This letter sets out our financial evaluation of the Rail Merger for inclusion in the Circular. Unless otherwise defined or the context otherwise requires, all terms defined in the Circular shall have the same meaning when used in this letter.

### 2. BASIS OF ADVICE

In formulating our opinions and recommendations, we have relied on the information supplied to us by MTRC and the opinions expressed by, and the representations of, the Directors and the management of MTRC, including those set out in the Circular. We have assumed that all the information and representations so supplied by the Directors and/or the management of MTRC and all information, opinions and representations referred to or contained in the Circular, for which the Directors and MTRC are solely and wholly responsible, were true, accurate, complete and not misleading at the time they were supplied, expressed or made, and remained so up to the date of the Circular. No representation or warranty, expressed or implied, is made by us on the accuracy, truth or completeness of such information, opinions and/or representations. We have also sought and received confirmation from the management of MTRC that no material fact or information has been omitted from the information supplied and that the representations made or opinions expressed have been arrived at after due and careful consideration.

While we have taken reasonable steps to satisfy the requirements under Rule 13.80 of the Listing Rules, we have not carried out any independent verification of the information, opinions or representations given or made by or on behalf of MTRC or KCRC or their respective advisers, nor have we conducted an independent investigation into the business affairs or assets and liabilities of MTRC or KCRC or any of the other parties involved in the Rail Merger.

We have not made an independent evaluation or appraisal of the assets and liabilities of MTRC or those of KCRC and we have not been furnished with any such evaluation or appraisal, except for the valuation report in respect of the property portfolios of the Enlarged Group as set out in Appendix VIII to the Circular. We are not experts in the valuation of properties and have relied solely upon the valuation report prepared by Jones Lang LaSalle in our evaluation of the Property Package.

Where information in this letter relating to the Rail Merger, MTRC and KCRC has been extracted from published or otherwise publicly available sources, the sole responsibility of Merrill Lynch has been to ensure that such information has been correctly extracted from the relevant sources.

Our scope of work does not require us to express, and we do not express, any opinion on the future prospects of the Company. We are not requested to and have not provided advice concerning the structure, the specific amount of the payments, the timing, pricing, size, feasibility, or any other aspect of the Rail Merger. We do not comment on the merits or otherwise of the Rail Merger other than to form an opinion, solely from a financial point of view, as to the fairness and reasonableness of the Rail Merger for the purpose of making a recommendation to the Independent Board Committee and the Independent Shareholders. Any evaluation of and/or comment on the strategic or commercial merits of the Rail Merger or on the prospects of the Company remain the sole responsibility of the Directors. In addition, we express no opinion as to whether the Rail Merger will be completed or achieved.

In preparing this letter and in giving any opinion or advice herein, we have only had regard to the Rail Merger in isolation and not in connection with any other business plan, transaction or strategy, past or present, with regard to the Company, the Group or the Enlarged Group nor as part of a series of other transactions or arrangements.

Our opinion is necessarily based upon market, economic, industry and other conditions as they existed and could be evaluated upon, and on the information available to us as at the date of this letter. We have no obligation to update this opinion to take into account events occurring after the issue of this letter. As a result, circumstances could develop prior to completion of the Rail Merger that, if known at the time we rendered our opinion, would have altered our opinion. We assume no responsibility or liability in or in relation to such circumstances.

In rendering our advice and giving our recommendation, we have not had regard to the general or specific investment criteria, financial situation, risk profile, tax position, objectives, needs or constraints of any Shareholder. It is also not possible to opine on whether or not the Rail Merger is in the interests of each individual Shareholder. As different Shareholders could have different investment criteria and objectives, we would recommend any Shareholder who may require advice in relation to any aspect of the Circular, or as to the action to be taken, to consult a licensed securities dealer, bank manager, solicitor, professional accountant, tax adviser or other professional adviser. The opinion contained in this letter is only intended to provide one of the bases on which the Independent Board Committee may make their recommendation to the Independent Shareholders on how to vote and on which the Independent Shareholders may decide how to vote, in respect of the Rail Merger.

The Company has been separately advised by its own professional advisers with respect to the Rail Merger and the preparation of the Circular (other than this letter). We have had no role or involvement and have not provided and will not provide any advice (financial or otherwise) whatsoever in the preparation, review or verification of the Circular (other than this letter). Accordingly, we take no responsibility for and express no views, whether expressly or implicitly, on the contents of the Circular (other than this letter).

Nothing contained in this letter should be construed as an opinion or view as to the trading price or market trends of the Shares or any other securities of the Company at any particular time in the past, present or future. We are not expressing any opinion herein as to the price at which the Shares or any other securities of the Company may trade upon approval and completion or rejection of the Rail Merger or on the future financial or other performance of the Company. Furthermore, nothing contained in this letter should be construed as a recommendation to hold, sell or buy any Shares or any other securities of the Company.

Whilst a copy of this letter in its entirety may be reproduced in the Circular, none of the Company, the Directors and any other person may reproduce, disseminate or quote this letter (or any part thereof) for any other purposes at any time and in any manner without the prior written consent of Merrill Lynch in each specific case. In the event of inconsistency, the English text of this letter shall prevail over the Chinese translation of this letter.

Our opinion in relation to the Rail Merger should be considered in the context of the entirety of this letter and the Circular.

## 3. ELIGIBILITY TO GIVE ADVICE

Apart from normal professional fees for our services to MTRC in connection with this appointment, and the indemnity given to us and our affiliates and their respective directors, officers, employees, agents and controlling persons by MTRC against certain liabilities and expenses in connection with this appointment, no arrangement exists whereby we will receive any fees or benefits from MTRC or any of its associates (as defined under the Listing Rules). In addition, we were not requested to and did not provide services in relation to the Rail Merger other than the delivery of this letter. We did not participate in the negotiations with respect to the Rail Merger.

As at 20 August 2007, as far as we know, companies associated with Merrill Lynch were beneficially interested in an aggregate shareholding of 11,107,599 Shares, and had voting control over and discretionary power to dispose or transfer 1,499,136 Shares. The above aggregate interests represent approximately 0.23% of the issued share capital of the Company.

We do not consider that the above interests affect the objectivity or impartiality of our advice, given the fact that the interests so held in the Company are no different from that of the Independent Shareholders in relation to the Rail Merger. We consider ourselves independent and qualified to give independent financial advice to the Independent Board Committee and the Independent Shareholders in relation to the Rail Merger in accordance with Rule 13.84 of the Listing Rules.

## 4. BACKGROUND TO THE RAIL MERGER

We have summarised for ease of reference the background to the Rail Merger as described by the Company in the Circular. Further details of the background to the Rail Merger are set out in section 2 of the Letter from the Board contained in the Circular.

In February 2004, the Government invited the Company and KCRC to commence discussions relating to a possible rail merger on the basis of the following parameters:

(i) adoption of a more objective and transparent fare adjustment mechanism;

(ii) abolition of the second boarding charge and review of the fare structure with the objective of reducing fares;

(iii) early resolution of interchange arrangements for new rail projects under planning, notably the Shatin to Central Link;

(iv) ensuring job security for frontline staff of both the Company and KCRC at the time of the rail merger; and

(v) provision of seamless interchange arrangements in the long run.

On 11 April 2006, the Government and the Company entered into the Memorandum of Understanding which, amongst other things, addressed each of the 5 parameters above, set out the structure and key terms of the Rail Merger and formed the basis upon which the Transaction Documents were agreed. The Memorandum of Understanding recorded the understanding reached between the Company and the Government as to the structure and key terms of the Rail Merger as at 11 April 2006. These terms were not legally binding and created no legal obligations on either party as to the final structure or terms of the Rail Merger.

Following the signing of the Memorandum of Understanding, the Company, the Government and KCRC negotiated the terms of the Transaction Agreements for the implementation of the Rail Merger which were entered into on the Signing Date (other than those which are to be entered into at a later date).

The Rail Merger addresses the 5 parameters as follows:

*Parameter 1: Adoption of a more objective and transparent fare adjustment mechanism*

At present, both the Company and KCRC have fare autonomy, and they set their fares in accordance with prudent commercial principles having regard, amongst other things, to prevailing market conditions, competition from other transport modes and their respective financial objectives. One of the parameters set by the Government in February 2004 was the adoption of a more objective and transparent fare adjustment mechanism. The Company and the Government have agreed upon a formulaic approach, the Fare Adjustment Mechanism or FAM, for determining future fare adjustments to replace fare autonomy after the Rail Merger. This has been incorporated into the Operating Agreement.

The Fare Adjustment Mechanism will provide that any adjustment to specified fares should be linked to changes in the Government Composite Consumer Price Index and changes in the Nominal Wage Index (Transport Services Sector) published by the Census & Statistics Department of Government, and taking into account a productivity factor.

*Parameter 2: Abolition of second boarding charge and review of the fare structure with the objective of reducing fares*

In light of the potential synergies that the Company expects to realise from the Rail Merger, the Company has reviewed its existing fare structures with a view to rationalising the fare levels for the Company.

The Company estimates that there will be a minimum of a 10% fare reduction for all passengers travelling on journeys with fares at HK$12 or above, and a minimum of a 5% fare reduction for all passengers travelling on journeys with fares between HK$8.50 and HK$11.90. The Company states in the Circular that the proposed fare reductions are made possible partly by synergies that the Company expects to achieve as a result of the Rail Merger.

In addition, for one year commencing on the Merger Date, the Company shall provide an Octopus concessionary fare of HK$2 for all journeys on the Integrated Railway made by the elderly (being persons aged 65 or above) on Sundays and public holidays. The Company will maintain the status quo as at the date of the Memorandum of Understanding with respect to Student Fares discounts by continuing to provide a discount of 50% on Student Fares for the MTRC Railway and no discount on Student Fares for the KCRC Railway, subject to the Fare Adjustment Mechanism applying to the Student Fares from and including the Merger Date.

Furthermore, the Company has agreed that it will not increase fares to which the Fare Adjustment Mechanism applies until after 30 June 2009. For the period ending on the Merger Date, KCRC shall not increase fares for the KCRC Railway.

It is estimated by the Company in the Circular that the above fare reductions will amount to an annual, additional cost to the Company of HK$600 million.

*Parameter 3: Early resolution of interchange arrangements for new rail projects under planning, notably the Shatin to Central Link*

In 2002, KCRC was selected to proceed with the planning of the SCL project and, in 2004, submitted its draft final proposal to the Government. The draft final proposal included the extension of East Rail across Victoria Harbour to Hong Kong Island and the extension of MOS Rail to West Rail via East Kowloon. In addition, the Company and KCRC jointly developed a scheme for the SCL to be implemented should the Rail Merger proceed for the purpose of ensuring the early resolution of the interchange arrangements for the SCL.

*Parameter 4: Ensuring job security for frontline staff at the time of the rail merger*

On the Merger Date, the Company is required to sign, seal and deliver a deed poll in favour of Relevant Frontline Staff. The deed poll provides that the Company shall not terminate the employment contract of any Relevant Frontline Staff member for any reason that relates to the process of integrating the operations of the Company and KCRC pursuant to the Rail Merger.

According to the assessments made by the Company and KCRC, the Rail Merger could achieve overall staffing synergies of 650-700 in number of employees. This would create direct cost savings in a number of areas of the Company's business. However, it is also estimated that more than 1,300 vacancies will be created in the first 3 years after the Rail Merger through various means, including the commissioning of new railways and property management as well as through retirement and turnover.

The Company envisages that the majority of its and KCRC's existing staff will stay in their current jobs after the Rail Merger.

From the Merger Date (and, in the case of KCRC staff, pursuant to the MTR Ordinance), staff of the Company and KCRC would be employed on their prevailing terms and conditions of employment, but it is expected that shortly after the Merger Date there would be a single set of terms and conditions of employment and grading structure for all staff of the Company.

*Parameter 5: Provision of seamless interchange arrangements in the long run*

The integration of the operation of the two railway systems are expected to improve passenger convenience and reduce journey time. The Company has undertaken that it will complete a specified programme of milestone dates and preparatory work relating to station modification and the provision of barrier free interchanges at Nam Cheong, Mei Foo and Kowloon Tong stations, the integration of operations at those stations and at Tsim Sha Tsui station, the integration of the ticketing systems for Octopus users and single journey tickets users and the establishment of an integrated communication coordination centre and hotline system. Up to the Merger Date, the external costs and expenses of implementing the seamless interchange programme shall be borne equally by the Company and KCRC, and each of them shall bear its own internal costs and expenses. All costs and expenses of the seamless interchange programme incurred on or after the Merger Date shall be borne by the Company.

## 5. THE RAIL MERGER PACKAGE AND CONSIDERATION

We have summarised below for ease of reference information on the Rail Merger package and consideration as described by the Company in the Circular. Further details on the Rail Merger package and consideration are set out in section 3 of the Letter from the Board contained in the Circular.

### (a) The Rail Merger Package

Pursuant to the Transaction Documents, the Rail Merger includes, amongst other things:

(i) pursuant to the Sale and Purchase Agreement, the sale and purchase of the Purchased Rail Assets and the KCRC's subsidiaries;

(ii) pursuant to the Property Package Agreements and the Sale and Purchase Agreement, arrangements for the transfer to the Company of the economic benefits of the Property Package;

(iii) pursuant to the Rail Merger Ordinance, the expansion of the Franchise to enable the Company to operate the Integrated Railway under a single franchise for an initial period of 50 years from the Merger Date;

(iv) pursuant to the Operating Agreement, the operation by the Company of the Integrated Railway as an integrated system;

(v) pursuant to the Service Concession Agreement, an arrangement under which, amongst other things:

  (a) KCRC will grant the Service Concession to the Company for an initial period of 50 years in order to enable the Company to access, use and operate the Concession Property to provide the KCRC Services. The Service Concession will end if the Franchise relating to the KCRC Railway is revoked; and

  (b) the Company will provide the KCRC Services to the Required Standards;

(vi) pursuant to the KSL Project Management Agreement, an arrangement under which the Company will act as KCRC's agent in connection with the KSL under certain circumstances;

(vii) pursuant to the West Rail Agency Agreement, an arrangement under which the Company will act as an agent for KCRC and the West Rail Subsidiaries, in connection with the development of properties at, adjacent to or above West Rail;

(viii) pursuant to the US CBL Assumption Agreements, arrangements under which the Company will become jointly liable, together with KCRC, for certain of KCRC's obligations to the counterparties of the CBLs (indemnities in relation to which are contained in the Merger Framework Agreement and the US CBL Allocation Agreement);

(ix) pursuant to the US CBL Allocation Agreement, arrangements delineating the rights and obligations between KCRC and the Company in respect of the exercise of joint rights and the performance of joint obligations under the terms of the CBLs;

(x) in accordance with the Liaison Committee Letter, provisions relating to material decisions of KCRC between the Signing Date and the Merger Date; and

(xi) other transactions and matters as set out in the Merger Framework Agreement and the other Transaction Agreements.

The Company, the Government and KCRC have acknowledged that the Rail Merger and the Transaction Agreements comprise an integrated package of terms.

The Rail Merger excludes the Excluded Assets, which will be retained by KCRC. The Company states in the Circular that the Rail Merger has been structured to ensure that the Company obtains the necessary rights to access, use and operate the Integrated Railway and the Property Package. The Company further states in the Circular that the Excluded Assets are not required by the Company for these purposes.

### (b) Payments

The Company will be required to pay to KCRC the following payments:

(i) Initial payments: Upfront Payment of HK$4.25 billion, payable under the Service Concession Agreement, being the upfront fee for the right to operate the Service Concession and the consideration for the Purchased Rail Assets, and a further Upfront Property Payment of HK$7.79 billion payable under the Merger Framework Agreement in consideration for the execution of the Property Package Agreements and the sale of the shares in the KCRC Subsidiaries under the Sale and Purchase Agreement, in each case payable on the Merger Date;

(ii) Fixed annual payments: of HK$750 million payable under the Service Concession Agreement, for the right to use and operate the Concession Property for the operation of the Service Concession, in arrears on the day immediately preceding each anniversary of the Merger Date which falls during the Concession Period in respect of the 12 month period up to and including the date on which such payment falls due; and

(iii) Variable annual payments: payable under the Service Concession Agreement, for the right to use and operate the Concession Property for the operation of the Service Concession, in each case, calculated on a tiered basis by reference to the amount of revenue from the KCRC System (as determined in accordance with the Service Concession Agreement) for each financial year of the Company.

As a complete package deal, other than the payment elements described above, the Company states in the Circular that no specific allocation of payments has been made between the various elements of the Rail Merger.

The Company has stated in the Circular that the above payments were determined by the Directors after arm's length negotiations with the Government and KCRC. We are informed that, in arriving at the consideration, the Directors did not place reliance on any single factor but considered numerous factors as a whole, including financial considerations, such as capital expenditure requirements, credit ratios, discounted cashflow, market trading multiples, the Property Package and the payment structure, together with a broader range of issues including the strategic growth and market positioning of the Company, and the heightened degree of certainty relating to the fares of the Company.

## 6. REASONS FOR AND BENEFITS OF THE RAIL MERGER STATED BY THE COMPANY

It is stated in the Letter from the Board contained in the Circular that the Company considers that the terms of the Rail Merger will be beneficial to the Company for a number of reasons which we have summarised below for ease of reference:

### (a) Enhancement of Value

As a result of the Rail Merger, the Company expects that there will be a significant increase to the revenue base of the Company. The Company further expects that such increase, together with the other benefits of the Rail Merger, will contribute to the accretion of earnings per Share ("**EPS**") and cashflow and enhancement to the property of the Company.

### (b) Benefits to the Rail Business

#### *Expanded Rail Network and Increased Rail Patronage*

The Rail Merger will provide the Company with a significant growth opportunity through an expanded rail network, which will extend the Company's operations within Kowloon and into the New Territories. The expansion will also extend the Company's operations into the Mainland, providing, amongst other things, a platform to further expand its operations into the Pearl River Delta region. The route length of the Company's rail network after the Rail Merger will be increased by 131.9% from 91 km to 211 km. With 2006 figures as a reference, on a pro-forma basis, the Company estimates that the expanded rail network (i) would bring a 65.9% increase in the Company's patronage from 876 million to 1,453 million (which, however, includes about 102 million passengers who interchange between the two systems and which figure will, from the Merger Date, be deducted because passengers who interchange between the two systems will be counted as having made only one journey on the Integrated Railway) and (ii) a 70% fare revenue growth from HK$6,523 million to HK$11,121 million (excluding the estimated impact of the proposed fare reduction of HK$600 million and the FAM). The expanded rail network is expected by the Company to increase the Company's franchised public transport market share in Hong Kong from approximately 25% to approximately 40%.

Beyond immediate rail network growth, the Rail Merger will also bring future expansion in the form of the KSL, and potentially possible future railway lines such as Northern Link and Express Rail Link, as well as the SCL.

The Company further anticipates that with the integration of the two railway networks, allowing for seamless journeys from one end of the Integrated Railway to the other, together with lower fares and improved planning, design and construction of new extensions, the Company will have the ability to enhance its competitiveness over other transport providers in Hong Kong and further increase its patronage.

The Company also expects that its rail-related business will benefit from the Rail Merger which will be integrated with KCRC's rail-related activities such as its duty free business, advertising and telecommunications. Non-fare rail-related revenues would increase by 50.6%, from HK$1,542 million to HK$2,322 million (based on an aggregation of the relevant revenues of the Company and KCRC for the year ended 31 December 2006).

The Company's current Franchise runs for a term of 50 years from June 2000. It should be noted that, following the Rail Merger, the Company's franchise relating to the Integrated Railway will be extended to run for a term of 50 years commencing on the Merger Date.

#### *Objective Fare Adjustment Mechanism*

One of the parameters set by the Government for the Rail Merger was the introduction of the proposed Fare Adjustment Mechanism or FAM. The adoption of the FAM, being a direct-drive formula, will require the Company to adjust its fares according to a pre-determined formula based on changes in the composite consumer price index, wage index and a productivity factor. As a result, although fares may be reduced as a result of fluctuations in such factors, fares may also be increased. The Company believes that the FAM offers a predictable, objective and transparent solution to the question of fare adjustment as it is a direct-drive formula. Consequently, it gives the Company a measure of certainty with respect to its fares. The Company therefore considers that the FAM will be beneficial to the Company particularly in the long term.

#### *Creation of Synergies*

Following the Rail Merger, the Company will operate and manage the combined businesses of the Company and KCRC in an integrated manner. By applying best practices to the expanded rail network, the Company expects that there will be a creation of both cost and revenue synergies in a number of business areas. The Company expects that the Rail Merger will create estimated annual synergies of up to HK$450 million once all the proposed synergy programmes are fully implemented (which is expected to be over the first 3 years after the Merger Date). As stated in the Letter from the Board contained in the Circular, these identified synergies are based on an extensive joint study by the Company and KCRC. The Company also expects that there will be some synergies from further revenue enhancements in combining the fare and non-fare businesses of the Company and KCRC. However, the majority of the estimated synergies are cost synergies which are expected to come from transfer of best practices and operational efficiencies, procurement synergies, and streamlining of overlapping activities and reduction of overheads.

### (c) Benefits to the Property Business

As part of the Rail Merger, the Company will acquire the economic benefits of the Property Package which comprises property development rights, investment properties and property management rights. It should be noted that there would be a pre-tax surplus of HK$2,824 million (HK$2,330 million post-tax) based on the difference between: (i) the valuation made by JLL of the property development rights and investment properties as at 31 July 2007; and (ii) the Company's acquisition cost for such rights and properties.

The Company believes that the Property Package will not only provide it with an increased land bank, but will also increase the Company's recurrent income from its investment property portfolio and property management rights. The Company's development land bank (being development rights and property development interests in relation to which property development profits have not been accounted for up to 30 June 2007) will increase by 54.3% from 23.2m sq ft to 35.8m sq ft (gross floor area). The Property Package will also enable the development of properties along and adjacent to the MTRC Railway and KCRC System to be managed in a coordinated manner.

Revenue from investment properties and property management would increase by 16.0% from HK$1,412 million to HK$1,638 million (based on an aggregation of the revenues of the Company and those of KCRC for the year ended 31 December 2006).

In addition, the Company will take up KCRC's role as development agent for the Government in respect of the West Rail properties (which comprises a total gross floor area of about 24.3m sq ft). The Company will receive from the West Rail Subsidiaries, in addition to cost recovery, a fee of 0.75% of the gross sale proceeds in respect of the unawarded West Rail development sites (comprising approximately 22.7m sq ft gross floor area) and 10% of the relevant profits accrued to the West Rail Subsidiaries under the development agreements in respect of the awarded West Rail development sites (comprising approximately 1.6m sq ft gross floor area).

### (d) Benefits of the Rail Merger Transaction Structure

The rail component of the Rail Merger has been specially structured as a Service Concession, thereby allowing the Company to acquire the rights to access and operate the KCRC System and related assets whilst not assuming KCRC's existing debts (except as joint co-obligor with KCRC in relation to the CBLs) nor paying a significantly greater upfront payment. In addition, the Company believes that the transaction structure will also be beneficial to it in terms of cashflow, earnings enhancement and financial flexibility to the Company. The Company believes that the structure also offers some protection against future adverse changes in patronage and fares of the KCRC System as explained below.

The payment structure of the rail component includes the Upfront Payments, the Fixed Annual Payments and the Variable Annual Payments for the Concession Period. This payment structure alleviates the Company of the need to finance the entire transaction with a large upfront payment. It also allows the Company to fund a significant portion of the transaction consideration (being the Fixed Annual Payments and the Variable Annual Payments) from debt and internal resources each year. With no Variable Annual Payments to be made in respect of the first 36 months following the Merger Date, the structure further enhances the cashflow and earnings of the Company during these initial years.

#### *Credit Profile*

Although the Company's gearing on a pro-forma basis as at 30 June 2007 will increase to 57.7% (including capitalised Fixed Annual Payments) from 30.8%, this is similar to the gearing levels experienced by the Company in certain previous years (e.g. 2002: 59.3% and 2003: 55.2%). Although the Company's pro-forma interest cover for 2006 will fall to 4.6x (including interest on capitalised Fixed Annual Payments) from 6.7x before the Rail Merger, the Board regards this as an acceptable interest cover level. The Company also expects that the increased cashflow from the Rail Merger will reduce the gearing and enhance interest cover levels over time following the Rail Merger.

The above gearing and interest cover ratios have not taken into account the combined effect of: (i) the fare reduction; (ii) the implementation of the FAM; (iii) the payment of the Variable Annual Payment; and (iv) synergies (estimated by the Company to be up to HK$450 million and expected to be fully realised within the first 3 years after the Merger Date). It is stated in the Letter from the Board contained in the Circular that the Directors do not consider that items (i) to (iv) would have a material impact on the above pro-forma figures.

On 26 July 2007 Moody's Investors Services, Inc. ("**Moody's**") upgraded the Company's credit ratings to Aa2 and on 16 July 2007 and 4 July 2007, respectively, Standard & Poor's Ratings Services ("**Standard & Poor's**") and Rating and Investment Inc. announced that they had affirmed the Company's credit ratings.

***Variable Annual Payments***

It is important to note that the Variable Annual Payments are directly linked to the revenue attributable to the KCRC System and form an important part of the total consideration for the Rail Merger. Such Variable Annual Payments will provide the Company with a certain degree of protection against the risks associated with future adverse changes in the KCRC System Revenue as the amount of the Variable Annual Payments will vary with the revenue attributable to the KCRC System.

***Financing of KSL***

The transaction structure also stipulates that KSL will be incorporated into the Integrated Railway as Concession Property upon its completion, while the financing of the construction of KSL will remain with KCRC even after the Rail Merger. This arrangement will therefore enable the Company to access and operate KSL without the need to incur capital expenditure required for its construction. It should be noted that in the case of KSL, the Company will act as KCRC's agent in relation to the construction in return for a fee.

***Treatment of SCL***

In the case of SCL, the decision as to whether it proceeds remains with the Government. According to the Transport and Housing Bureau, the SCL remains a committed project for implementation. It stated in a paper to the LegCo Panel on Transport dated 16 July 2007 (LC Paper No. CB(1)2058/06-07(01)): *"The Administration has promised to make a decision on the way forward, including the scheme and timetable for the SCL within 6 months after the completion of the legislative process for the rail merger."* Under the terms of the Rail Merger, if, in its absolute discretion, the Government decides to implement the SCL, it will be treated in the same way as a New Separate Project in accordance with the Operating Agreement, except that the invitations referred to therein shall be to the Company only. The Company recognises that, if the SCL were to become incorporated into the Integrated Railway (whether under the concession approach or the ownership approach), certain benefits would accrue to the Company from its ability to invest in and/or operate SCL rather than it being owned or operated by a third party. Such benefits include the increase in the Integrated Railway's catchment area which could lead to increased patronage, relief of expected capacity constraints caused by the anticipated congestion on the Nathan Road corridor, and assistance in increasing the Company's market share of cross-harbour transport.

**(e) Benefits to Other Stakeholders**

***Retention of Employees***

The Rail Merger will give the Company a greater pool of experienced employees to staff its business requirements. The Company believes that the continued employment of both the Company's and KCRC's employees will be an essential element for the success of the Rail Merger integration process and the future of the Integrated Railway. According to the assessments made by the Company and KCRC, the Rail Merger could achieve an overall staffing synergy of 650-700 in number of employees. This would create direct cost savings in a number of areas of the Company's business. However, it is also estimated that more than 1,300 job vacancies will be created in the first 3 years after the Rail Merger through various means, including the enlargement of the property related business, the commissioning of new railways, retirement and turnover.

***Benefits to the Public***

The Government has stated to LegCo that an enhanced railway service resulting from the Rail Merger will encourage cross-district labour movements and in turn stimulate a series of economic and employment activities. The Rail Merger is expected to generate synergies to support the reduction in railway fares including the introduction of immediate fare reductions. The better interchanging arrangements brought about by an integrated railway network are expected to improve passenger convenience and travelling time, which are in line with the sustainability principles of providing a safe, accessible and efficient transport system. The Rail Merger is therefore expected not only to improve the growth prospects and profitability of the Company, but also to create an integrated regional and urban rail network for the people of Hong Kong with greater efficiency, increased convenience and enhanced connectivity.

Further details of the reasons for and benefits of the Rail Merger are set out in section 4 of the Letter from the Board contained in the Circular.

## 7. RISK FACTORS STATED BY THE COMPANY

The Independent Board Committee (in considering whether or not to recommend the Independent Shareholders to vote in favour of the EGM Resolution) and the Independent Shareholders (in considering whether or not to vote in favour of the EGM Resolution) should consider all of the information set out in the Circular, including the risk factors set out in Appendix I to the Circular.

We have summarised below for ease of reference certain information on the risk factors relating to the Rail Merger as described by the Company.

Any of the risks described below could cause the financial performance of the Company to differ significantly from the goals, plans, objectives, intentions and expectations expressed in the Circular. If any of the following risks and uncertainties actually occur, the business, financial condition or operating results of the Company could be materially and adversely affected.

### (a) Risks Relating to the Existing Business of KCRC

(i) Patronage and related fare revenue of the KCRC Railway may be susceptible to intensified competition as a result of changes relating to the ability of other transport providers to provide additional or cheaper services.

(ii) There is only limited recourse contained in the Transaction Agreements in respect of defects or problems with the Concession Property.

### (b) Risks Relating to the Structure of the Rail Merger Transaction

(i) The Fare Adjustment Mechanism is not directly related to the costs of operating the Integrated Railway.

(ii) Breach of the MTR Ordinance or the Operating Agreement with respect to the Franchise relating to the KCRC System may potentially result in fines and/or, in an extreme case, revocation of the Franchise relating to the MTRC Services.

(iii) The Company is contracting with KCRC without any formal guarantee from the Government. After the Rail Merger, KCRC's only substantial asset will be its right to receive payments from the Company with respect to the Service Concession.

### (c) Risks of Potential Benefits of the Rail Merger Not Transpiring

(i) Expected synergies not materialising.

(ii) Operational interface issues may not be fully resolved before joint operations commence.

(iii) Retention of employees.

(iv) Changes in political views, transport policies, regulator scrutiny and/or public and media attention.

(v) The KCRC property business is subject to fluctuations in the Hong Kong property market as well as to general risks incidental to the ownership and management of properties. These fluctuations may affect the targeted profits of the Company.

Further details on the risk factors relating to the Rail Merger are set out in Appendix I to the Circular.

## 8. SCOPE OF WORK

In the course of our financial evaluation of the Rail Merger, we have, amongst other things:

(i) reviewed the information contained in the public announcements made by MTRC on 11 April 2006 and 9 August 2007 and in the Circular, including "Unaudited Pro Forma Financial Information of the Enlarged Group" included in Appendix VII to the Circular and the property valuation report included in Appendix VIII to the Circular;

(ii) reviewed the Memorandum of Understanding entered into by the Government and the Company on 11 April 2006;

(iii) reviewed certain LegCo documents related to the Rail Merger;

(iv) reviewed certain publicly available financial statements and other information relating to the Company and KCRC (including the unaudited interim financial results of the Company for the 6 months ended 30 June 2007);

(v) reviewed certain other information, including financial budgets and forecast assumptions relating to the business, earnings, cashflow, assets and prospects of the Company and the KCRC System furnished to us by the management of MTRC and its advisers;

(vi) reviewed from a financial point of view the KSL Project Management Agreement, the West Rail Agency Agreement and the Outsourcing Agreement in the context of the Rail Merger as a whole;

(vii) reviewed certain information related to synergies that the Company expects to result from the integration of MTRC Railway and the KCRC System, including the Joint Merger Report prepared by MTRC and KCRC dated 16 September 2004;

(viii) reviewed certain public information, including, but not limited to, historical and forecast economic and census data published by the Government, as well as third-party research reports, press articles, and websites related to MTRC, KCRC and the Rail Merger;

(ix) reviewed the latest MTRC ratings reports by Standard & Poor's, published on 16 July 2007 and 26 July 2007, and by Moody's, published on 16 July 2007 and 26 July 2007;

(x) conducted discussions with the management of the Company relating to the 5 parameters set by the Government as a basis for the Rail Merger;

(xi) conducted discussions with the management of the Company and KCRC on the past and current operations and financial condition of the Company, as well as the future strategy of MTRC and KCRC;

(xii) conducted discussions with the management of MTRC on the structure and terms of, and reasons for, the Rail Merger and its key features, including the FAM and the Variable Annual Payment mechanism;

(xiii) conducted discussions with the management of the Company and its financial advisers with respect to assumptions made by the Company on financial forecasts and synergies relating to the Rail Merger;

(xiv) conducted discussions with Jones Lang LaSalle on the valuation methodologies and assumptions adopted for its property valuation report relating to the KCRC Investment Properties and KCRC Property Development Rights (as defined below in the section 9.(f) "Property Package" of this letter);

(xv) undertaken valuation analysis of the Service Concession and the Purchased Rail Assets, including various sensitivity analyses on the key assumptions adopted;

(xvi) undertaken retrospective analysis to calculate the hypothetical fare changes based on the FAM and compared such fare changes against MTRC's actual, historical announced fare changes to evaluate the potential value implications of the FAM to MTRC;

(xvii) undertaken analysis to evaluate the possible impact on the Company of inflation on the calculations of the Variable Annual Payment;

(xviii) undertaken analysis on the potential value to the Company of the revenue and cost synergies that the Company expects to be derived from the Rail Merger, and performed various sensitivity analyses on the possible value of such synergies;

(xix) assessed the valuation methodologies and assumptions used by Jones Lang LaSalle to value the KCRC Investment Properties and KCRC Property Development Rights, and compared MTRC's acquisition consideration for the KCRC Investment Properties and KCRC Property Development Rights with Jones Lang LaSalle's professional valuation of the KCRC Investment Properties and KCRC Property Development Rights as at 31 July 2007 as set out in Appendix VIII to the Circular;

(xx) evaluated the pro-forma impact of the Rail Merger on the reported EPS, cashflow, gearing and dividend policy of the Company based on relevant calculations by the Company contained in the Circular; and

(xxi) reviewed such other financial studies and analyses and performed such other investigations and taken into account such other factors as deemed by us to be necessary.

## 9. FINANCIAL ASSESSMENT OF THE RAIL MERGER

In undertaking our financial assessment of the Rail Merger as at the Latest Practicable Date, we have analysed the key terms and components of the Rail Merger individually from a financial point of view, including:

(a) the Service Concession and Purchased Rail Assets;

(b) the Fare Adjustment Mechanism;

(c) the Variable Annual Payment mechanism and the impact of inflation and deflation;

(d) the impact of increasing competition on KCRC's cross-boundary business;

(e) the synergies that the Company expects from the Rail Merger;

(f) the Property Package; and

(g) the pro-forma financial effects of the Rail Merger on MTRC as calculated by the Company.

A summary of our analysis with respect to each of the above key components of the Rail Merger is set out below.

***It should be noted that while we have performed financial analysis on each major component of the Rail Merger, our advice is based on an overall financial assessment of the Rail Merger as a whole. Our analysis of the possible impact on the Company, from a financial point of view, of any component part of the Rail Merger should not be considered individually.***

We have assumed 1 January 2008 as the Merger Date (the "**assumed Merger Date**") for all of our illustrative analyses (unless otherwise stated).

### (a) Service Concession and Purchased Rail Assets

#### *Valuation Methodology and Key Assumptions*

We have adopted the net present value methodology to assess on an illustrative basis the economic value of the Service Concession and the Purchased Rail Assets to MTRC.

The net present value methodology is based on the theory that the economic value of a transaction is equivalent to the sum of the projected incremental free cashflows generated by the transaction, discounted at a rate that reflects the risks associated with those cashflows, net of the initial investment costs associated with the transaction. Subject to the reasonableness of the assumptions adopted, the net present value derived from such analysis is positive, the transaction can be expected to create positive economic value.

As the first step of our analysis, based on the information set out in the Circular, we have calculated the incremental pro-forma rail and related cashflows from the KCRC System attributable to the Company for the 12-months ended 31 December 2006 excluding expected synergies (the "**KCRC System Cashflows**") as follows:

| | |
|---|---|
| KCRC System net cash inflow from operating activities | |
| Minus: | Fare reduction |
| Plus: | FAM |
| Minus: | Fixed Annual Payment |
| Minus: | Variable Annual Payment |
| Minus: | KCRC System capital expenditure |
| Plus: | KCRC receipts on sales of fixed assets |
| **KCRC System Cashflows** | |

We have confirmed with the Company that the above is an accurate and reasonable way of calculating the KCRC System Cashflows. In calculating the KCRC System Cashflows, we have taken into account the cashflows (both inflows and outflows) related to the KCRC System and associated with the Rail Merger, as detailed in the Letter from the Board contained in the Circular and Appendix VII to the Circular titled "Financial Information of the Enlarged Group," including the section titled "Notes to the Unaudited Pro Forma Financial Information." Based on our discussions with the management of the Company, we believe that it is reasonable to assume that the estimates set out in Table 1 below of each of the incremental cash inflows and outflows related to the KCRC System and associated with the Rail Merger have been prepared by the Company with due care and consideration.

We set out in Table 1 below the KCRC System Cashflows, calculated based on the information provided in the Circular.

**Table 1**

***KCRC System Cashflows Excluding Synergies***

| **(HK$ in millions)** | **Pro-forma for the 12-months Ended 31 December 2006** |
|---|---|
| KCRC System net cash inflow from operating activities (1) | 2,719 |
| Fare reduction (2) | (600) |
| FAM (3) | 70 |
| Fixed Annual Payment (4) | (750) |
| Variable Annual Payment (5) | (280) |
| KCRC System capital expenditure (1) | (389) |
| KCRC receipts on sales of fixed assets (1) | 5 |
| **KCRC Cashflows** | **775** |

*(1) Source: Circular, Appendix VII - "Unaudited pro-forma combined cashflow statement of the Enlarged Group for the year ended 31 December 2006."*
*(2) Source: Circular, Appendix VII - "Notes to the Unaudited Pro Forma Financial Information"; notes 8.(i).*
*(3) Source: Circular, Letter from the Board - "Reasons for and Benefits of the Rail Merger."*
*(4) Source: Circular, Letter from the Board - "The Rail Merger Package and Consideration."*
*(5) Source: Circular, Letter from the Board - "Reasons for and Benefits of the Rail Merger."*

The net present value methodology is an internationally accepted and commonly used valuation methodology. This valuation methodology is, however, highly sensitive to the assumptions adopted, notably with regards to the forecast cashflows and discount rate applied to those cashflows. To address these issues, we have adopted the following conservative approach:

(i) we have relied on the KCRC System Cashflows attributable to the Company for the 12-months ended 31 December 2006, as set out in Table 1 above, and made the following assumptions and adjustments to derive the "**Adjusted KCRC System Cashflows**" for the purpose of our illustrative analysis:

(a) with the exception of the adjustments noted below, we have assumed that the incremental pro-forma KCRC System Cashflows attributable to MTRC for the 12-months ended 31 December 2006 remain constant each year for the entire illustrative Concession Period (the "**Zero Growth Case**" scenario). ***Note that this means that we have assumed zero nominal growth (and negative real growth in periods of inflation) in the KCRC System Cashflows throughout the entire 50-year illustrative Concession Period***;

(b) we have excluded the positive adjustment of HK$70 million related to the FAM, as this estimate represents a potential increase of approximately +1.35% which is below the ±1.5% threshold required for the FAM to be implemented, as disclosed in Appendix VII to the Circular. Under the FAM, adjustments not applied in any year, as a result of being below the ±1.5% threshold, would be carried over to be applied to the following year's FAM calculation. ***Note that our illustrative analysis is therefore conservative as it assumes no FAM adjustment for the entire 50-year illustrative Concession Period. Consequently, our Zero Growth Case illustrative net present value analysis assumes no fare increase from the 2006 fare levels for the entire 50-year illustrative Concession Period but includes the one-time fare reduction of HK$600 million***;

(c) we have excluded the negative adjustment of HK$280 million related to the Variable Annual Payment for the first 3 years of the illustrative Concession Period only, as the Variable Annual Payment is not required to be paid until 3 years after the Merger Date;

(d) we have excluded the positive adjustment of HK$5 million related to KCRC receipts on sales of fixed assets, as we understand from the management of the Company that this is not recurring in nature;

(e) based on our discussions with the management of the Company and our review of the relevant historical KCRC figures supplied to us by the management of the Company, we have assumed a 30.0% depreciation tax-allowance on the incremental KCRC System capital expenditure; and

(f) we have fully tax-effected the resultant, adjusted pro-forma cashflows at the Hong Kong corporate tax rate of 17.5% per annum for each year of the illustrative Concession Period;

(ii) we have assumed that all of the Adjusted KCRC System Cashflows are received on 30 June of each respective year during the illustrative Concession Period in order to calculate the illustrative net present value of the resultant Adjusted KCRC System Cashflows based on our estimate of the discount rate or weighted average cost of capital (the "**WACC**") for the Service Concession and Purchased Rail Assets. We consider that it is reasonable to assume that all revenues and costs are incurred on 30 June of each respective year for the purpose of our illustrative net present value analysis as we understand that there is no material cyclicality to the rail and related businesses of KCRC based on our discussions with the management of the Company and the management of KCRC and our review of certain historical monthly KCRC management accounts supplied to us by the Company;

(iii) in calculating the illustrative net present value of the resultant Adjusted KCRC System Cashflows, we have assumed a total upfront cost as of 1 January 2008 consisting of the Upfront Payment of HK$4.25 billion as well as certain one-off, pro-forma cash charges of HK$306 million, as disclosed in Appendix VII to the Circular. The one-off, pro-forma cash charges relate to: (i) accounts payables in respect of stores and spares (HK$12 million); (ii) accrued liabilities of a capital nature (HK$99 million); and (iii) other obligations of KCRC (HK$195 million), and represent KCRC cash liabilities as at 1 January 2006, which would have been assumed by MTRC, if the Rail Merger had been effective on 1 January 2006. We have excluded a liability of HK$70 million related to accrued annual leave, as we understand from the management of the Company that this is a non-cash charge. ***Shareholders should note that the actual one-off charges that MTRC is required to assume at the Merger Date may be different from the HK$306 million pro-forma figure we have assumed based on the actual accruals, liabilities and other obligations of KCRC at the Merger Date***; and

(iv) we have then performed sensitivity analyses on the Adjusted KCRC System Cashflows and the discount rate.

### *Adjusted KCRC System Cashflows*

We set out in Table 2 below the Adjusted KCRC System Cashflows that we have used in our illustrative net present value analysis.

**Table 2**

***Adjusted KCRC System Cashflows — Zero Growth Case Assumptions Excluding Synergies***

| | Adjusted KCRC System Cashflows For the Illustrative Concession Period | |
|---|---|---|
| **(HK$ in millions)** | **Year 1-3** | **Year 4-50** |
| KCRC System net cash inflow from operating activities | 2,719 | 2,719 |
| Fare reduction | (600) | (600) |
| FAM | — | — |
| Fixed Annual Payment | (750) | (750) |
| Variable Annual Payment | — | (280) |
| KCRC System capital expenditure | (389) | (389) |
| KCRC receipts on sales of fixed assets | — | — |
| Tax adjustment (1) | (219) | (170) |
| **Adjusted KCRC System Cashflows** | **761** | **530** |

*(1) 17.5% Hong Kong corporate tax rate applied to (net cash inflow from operating activities − fare reduction − Fixed Annual Payment − Variable Annual Payment − 30.0% depreciation tax-allowance for KCRC System capital expenditure).*

For the purpose of our illustrative Zero Growth Case net present value analysis (excluding synergies), we have assumed the following cashflows:

(i) HK$761 million per year for the first 3 years of the illustrative Concession Period; and

(ii) HK$530 million per year for the remaining 47 years of the illustrative Concession Period.

### *Estimate of Discount Rate Attributable to the Service Concession and the Purchased Rail Assets*

In order to determine the illustrative net present value of the Adjusted KCRC System Cashflows over the illustrative Concession Period, such cashflows have to be discounted by an appropriate WACC. The WACC is an internationally accepted and commonly used metric to determine the required rate of return of a particular project or transaction.

For a company whose capital structure is composed of debt and equity, the WACC is effectively the weighted average sum of the cost of equity and the tax-effected cost of debt, where each is added in proportion to its contribution to the overall capitalisation of the company.

The WACC is an estimate of the cost associated with financing the activities of a company and is therefore also an estimate of the minimum annual required rate of return to achieve positive economic value for the company as a whole. It is the appropriate discount rate to use for cashflows with risks that are similar to those of the overall company. As the key factors affecting the rail and related cashflows of MTRC and KCRC are similar, we believe it is reasonable to use an estimate of MTRC's WACC as an approximation of the discount rate that reflects the risks associated with the Adjusted KCRC System Cashflows.

We set out in Table 3 below our estimate of MTRC's WACC, adjusted to reflect the additional pro-forma debt that the Company will assume (as disclosed in Appendix VII — "Financial Information of the Enlarged Group" of the Circular) to finance, amongst other things, the Initial Payments for the Service Concession, the Purchased Rail Assets and the Property Package.

**Table 3**

***Estimation of MTRC's WACC***

| | |
|---|---|
| **Figures on MTRC** | |
| MTRC current share price (HK$) | 18.74 |
| Total MTRC shares outstanding (mm) (1) | 5,589 |
| MTRC market value (HK$mm) | 104,729 |
| MTRC total debt (HK$mm) (2) | 25,170 |
| Unaudited pro-forma debt adjustment (HK$mm) (2) | 11,277 |
| Enlarged Group unaudited pro-forma total debt (HK$mm) | 36,447 |
| MTRC weighted average interest rate on outstanding indebtedness (3) | 5.7% |
| Marginal tax rate (4) | 17.5% |
| MTRC after-tax cost of debt | 4.7% |
| **Beta of MTRC (5)** | |
| Levered beta (6) | 0.76 |
| Unlevered beta (7) | 0.63 |
| Pro-forma levered beta | 0.82 |
| **Macroeconomic Assumptions** | |
| Risk free rate (8) | 4.5% |
| Risk premium (9) | 7.5% |
| Expected market return | 12.0% |
| **WACC** | |
| MTRC cost of equity (10) | 10.6% |
| Weight of equity (11) | 74.2% |
| MTRC after-tax cost of debt | 4.7% |
| Weight of debt (12) | 25.8% |
| **WACC (13)** | **9.1%** |

*Note: All market data as of 20 August 2007.*

*(1) Source: MTRC, as at 30 June 2007.*

*(2) Source: Circular, Appendix VII, - "Unaudited pro-forma combined balance sheet of the Enlarged Group as at 30 June 2007."*

*(3) Source: Circular, Appendix IV - "Liquidity"; for the six months ended 30 June 2007.*

*(4) Current Hong Kong corporate tax rate.*

*(5) Beta is a measure of the volatility, or systematic risk, of a security in comparison to the market as a whole. Beta is measured using a linear regression analysis of the returns of a specific security relative to a market index.*

*(6) Source: Adjusted beta from Bloomberg. Calculated for the period from 21 August 2006 to 20 August 2007.*

*(7) Levered beta based on the pro-forma leverage resulting from the Rail Merger. The unlevered beta = (levered beta/(1 + ((1 - marginal tax rate) * total debt/equity)). Assumes Beta of debt equals zero.*

*(8) 10-year Hong Kong Government Exchange Fund Note rate. Source: Bloomberg.*

*(9) Hong Kong risk premium. Source: Bloomberg.*

*(10) Levered cost of equity equals (risk free rate + (adjusted beta * risk premium)).*

*(11) Weight of equity equals (market value / (market value + total debt)).*

*(12) Weight of debt equals (total debt / (market value + total debt)).*

*(13) WACC equals (weight of debt * after-tax cost of debt) + (weight of equity * cost of equity).*

Based on our analysis, MTRC has a WACC of approximately 9.1%.

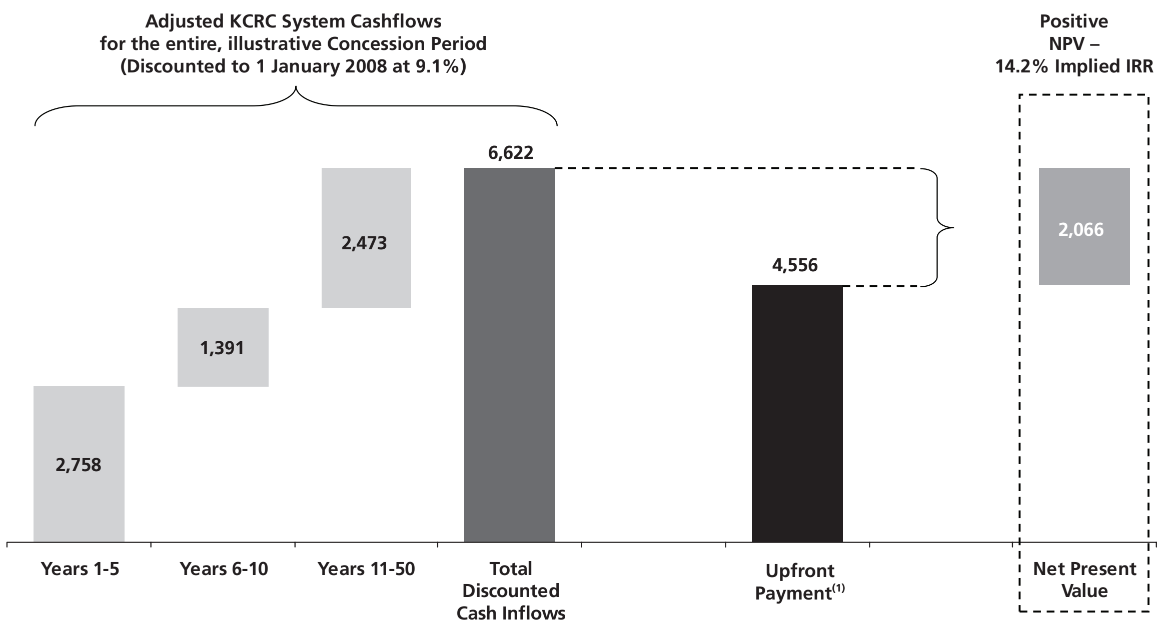
***Net Present Value Analysis of Adjusted KCRC System Cashflows — Zero Growth Case Excluding Synergies***

We set out in Chart 1 below the illustrative net present value calculation of the Adjusted KCRC System Cashflows outlined in Table 2 above, discounted using an estimated WACC of approximately 9.1%, based on the calculation set out in Table 3 above.

**Chart 1**

***Illustrative Net Present Value of Adjusted KCRC System Cashflows — Zero Growth Case Excluding Synergies***

***(HK$ in millions)***




(1) *Includes one-off cash charges of HK$306 million. These charges represent KCRC cash liabilities as at 1 January 2006 to be transferred or taken over by MTRC, assuming that the Rail Merger had been effective on 1 January 2006. Source: Circular, Appendix VII - "Notes to the Unaudited Pro Forma Financial Information"; note 7.(xiii).(a).*

***Based on the assumptions set out above, our illustrative analysis indicates that the Adjusted KCRC System Cashflows for the Concession Period in the Zero Growth Case scenario have a positive net present value of approximately HK$2,066 million excluding synergies.***

We note that in our illustrative analysis, due to the time value of money and the fact that no Variable Annual Payment will be payable in respect of the first 36 months following the Merger Date, the Adjusted KCRC System Cashflows for the initial years of the illustrative Concession Period account for a significant portion of the total value, with the cashflows from the first 5 years accounting for over 40% of the value of the total discounted cash inflows.

We have also considered the internal rate of the return, or average annual rate of return, implied by our illustrative discounted cashflow analysis of the Adjusted KCRC System Cashflows. Based on our illustrative analysis, the internal rate of return for the Adjusted KCRC System Cashflows over the illustrative Concession Period in the Zero Growth Case scenario is approximately 14.2%, which is significantly above our assumed, estimated WACC of approximately 9.1%.

The above net present value and internal rate of return calculations are illustrative only and depend on the underlying assumptions of our analysis. The final outcome could be better or worse than our illustrative calculations depending, in particular, on the actual incremental rail and related cashflows of the KCRC System achieved as compared to our illustrative, Adjusted KCRC System Cashflows.

However, we believe that our analysis and assumptions as stated above in our Zero Growth Case scenario are conservative for the following reasons:

(i) we have assumed zero growth in the incremental KCRC System Cashflows over the entire 50-year illustrative Concession Period. As our cashflow assumptions represent nominal cashflows, this implies negative real growth in cashflows in an inflationary period. However, the Government projects that the two key drivers of rail revenue growth, gross domestic product ("**GDP**") and population growth, will be positive in the foreseeable future:

  (a) The Government projects real GDP growth of 4.5% per annum between 2008 and 2011 [(1)]; and

  (b) The Government projects population growth of 0.7% per annum between 2008 and 2036 [(2)];

(ii) we have fully tax-effected the incremental, pro-forma cashflows in each year of the illustrative Concession Period at the Hong Kong corporate tax rate of 17.5%, which does not account for any tax deductions that may be available to MTRC and its substantial accumulated tax losses brought forward. Based on MTRC's annual reports, its effective tax rate for 2004, 2005 and 2006 was approximately 14.7%, 15.5% and 15.4%, respectively, which we understand relates mostly to the Company's deferred tax liabilities;

(iii) we have not taken into account the positive impact of the estimated synergies that the Company expects to generate from the Rail Merger in the above analysis. We have separately analysed the expected synergies and costs required to achieve such synergies in section 9.(e) below;

(iv) we have used MTRC's levered beta to calculate our estimated WACC for the Adjusted KCRC System Cashflows. MTRC's levered beta reflects the risks associated with its rail assets as well as its development and investment property businesses. We would generally expect a higher market risk associated with the property development business as compared to the rail business. The levered beta that we have used for our calculation of the value of the rail assets may therefore be overstated, resulting in a higher discount rate and, hence, a lower net present value estimate; and

(v) our estimated WACC for MTRC is a nominal rate which reflects a certain level of assumed inflation by the capital markets. In theory, this embedded inflation should be deducted from our estimate of the WACC, as we have assumed a Zero Growth Case scenario. In practice, it is not possible to estimate or calculate the precise level of future inflation assumed by the capital markets at any fixed point in time. Without this deduction, the discount rate that we have used is higher, resulting in a lower net present value estimate.

***Sensitivity Analyses on the Service Concession and the Purchased Rail Assets Valuation***

We have also undertaken sensitivity analyses on our Zero Growth Case Adjusted KCRC System Cashflows, and on our estimate of the WACC as follows:

(i) we have considered the impact of the Adjusted KCRC System Cashflows (as calculated in Table 2 above) being between 5.0% and 15.0% below or above our Zero Growth Case scenario in each year of the illustrative Concession Period; and

(ii) we have considered the impact of a WACC range of between 9.0% and 11.0%.

---

*(1) Source: The Government — The 2007-2008 Budget: Medium Range Forecast 2006-07 to 2011-12. (http://www.budget.gov.hk/2007/eng/appendices.htm)*

*(2) Source: Census and Statistics Department of the HKSAR — Hong Kong Population Projections, 2007-2036. (http://www.censtatd.gov.hk/hong_kong_statistics/statistics_by_subject/index.jsp)*

We set out in Table 4 below the results of our sensitivity analyses on the illustrative net present value of the Adjusted KCRC System Cashflows attributable to MTRC based on the assumptions set out above.

**Table 4**

***Illustrative Net Present Value of Adjusted KCRC System Cashflows Excluding Synergies — Sensitivity Analyses***

***(HK$ in millions)***

| | | Adjusted KCRC System Cashflows | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | *Assumed Percentage Decrease vs. Zero Growth Case* | | | **Zero Growth Case** | *Assumed Percentage Increase vs. Zero Growth Case* | | |
| | | (15.0%) | (10.0%) | (5.0%) | | +5.0% | +10.0% | +15.0% |
| | 9.0% | 1,112 | 1,452 | 1,779 | **2,117** | 2,447 | 2,787 | 3,114 |
| | 9.5% | 862 | 1,187 | 1,500 | **1,824** | 2,138 | 2,464 | 2,777 |
| **WACC** | 10.0% | 635 | 946 | 1,246 | **1,556** | 1,857 | 2,169 | 2,469 |
| | 10.5% | 427 | 726 | 1,013 | **1,311** | 1,600 | 1,899 | 2,187 |
| | 11.0% | 236 | 523 | 800 | **1,086** | 1,364 | 1,652 | 1,929 |

We note that, even assuming that the incremental Adjusted KCRC System Cashflows are 15.0% below our conservative Zero Growth Case assumptions in every year of the illustrative 50-year Concession Period, and assuming a discount rate of 11.0%, nearly 2.0% above our calculated WACC for MTRC of approximately 9.1%, the illustrative net present value is still positive.

***Impact of Growth***

As explained above, the two key drivers of rail revenue growth are GDP and population growth. We note that, based on its 2007-08 budget, the Government projects real GDP growth of 4.5% per year between 2008 and 2011. GDP growth forecasts beyond 2011 are not published. In addition, the Economic Intelligence Unit, a third party economic research and advisory firm, forecasts the average CCPI growth for Hong Kong between 2008 and 2030 to be approximately 2.4% per annum.

Purely for illustrative purposes, in addition to the Zero Growth Case scenario described above, we have considered the impact of growth on the illustrative net present value of the Adjusted KCRC System Cashflows. We have assumed: (i) a range of nominal growth rates of between 1.0% and 3.0% which are applied to the steady-state, pro-forma Year 4 cashflow for KCRC System of HK$530 million calculated in Table 2 above; and (ii) a WACC range of between 9.0% and 11.0%. All other assumptions of our illustrative net present value analysis are as stated above.

We set out in Table 5 below the illustrative net present value of the Adjusted KCRC System Cashflows based on such sensitivity analyses.

**Table 5**

***Illustrative Net Present Value of Adjusted KCRC System Cashflows Excluding Synergies — Assuming Nominal Growth Rates of 1.0% to 3.0%***

***(HK$ in millions)***

| | | Nominal Growth Case Cashflows | | | | |
|---|---|---|---|---|---|---|
| | | *Assumed Nominal Growth Rate on Year 4 Cashflow for KCRC System* | | | | |
| | | +1.0% | +1.5% | +2.0% | +2.5% | +3.0% |
| | 9.0% | 2,204 | 2,609 | 3,058 | 3,558 | 4,117 |
| | 9.5% | 1,851 | 2,217 | 2,622 | 3,071 | 3,571 |
| **WACC** | 10.0% | 1,531 | 1,863 | 2,229 | 2,634 | 3,084 |
| | 10.5% | 1,240 | 1,543 | 1,875 | 2,242 | 2,647 |
| | 11.0% | 976 | 1,252 | 1,555 | 1,887 | 2,254 |

As the illustrative growth rates applied above are nominal in nature, our illustrative analysis does not necessarily assume any real growth in cashflows. For example, if the applicable rate of inflation throughout the illustrative Concession Period is 3.0% per annum, below the historical average for Hong Kong of approximately 5.0% (between 1981 and 2006), then the illustrative net present value of the Adjusted KCRC System Cashflows would be approximately HK$4,117 million, assuming a discount rate of 9.0%, even if there is zero real growth in the cashflows.

***Appropriateness of Other Valuation Methodologies***

As part of our analysis, we have considered the merits of using comparable acquisition analysis to value the Service Concession and the Purchased Rail Assets. Comparable acquisition analysis is a common valuation methodology which derives an estimated value for a company or assets by reference to acquisition multiples paid for comparable companies or assets in precedent sale transactions.

The Service Concession is similar to a lease arrangement whereby MTRC has the right to access, use and operate the Concession Property and provide the KCRC Services for an initial period of 50 years. However, from a valuation standpoint, the Service Concession could be considered to be similar to an outright acquisition since the value to MTRC of any incremental cashflows generated by the KCRC System after year 50 will be minimal in present value terms. Therefore, comparable acquisition analysis could potentially offer a valid reference point in terms of relative value.

However, we do not believe it is an appropriate approach in this situation. First, we believe there are no directly comparable acquisition transactions we can use as a basis to derive the value of the Service Concession and the Purchased Rail Assets due to the unique structure of the Rail Merger. Second, this methodology assumes that the total consideration to be paid by an acquirer can be accurately determined at the outset. As set out in the Letter from the Board contained in the Circular, a portion of the consideration to be paid by MTRC to KCRC will be dependent upon the future Variable Annual Payments. To calculate the present aggregate value of the future Variable Annual Payments would require the use of 50-year cashflow forecasts. As it is not practicable to prepare meaningful financial forecasts for a 50-year period, it is not possible to determine accurately the total consideration in present value terms payable by MTRC for the Service Concession and the Purchased Rail Assets at the outset of the Rail Merger.

Similarly, we have also considered the merits of using trading multiple analysis to value the Service Concession and the Purchased Rail Assets. Trading multiple analysis is also a common methodology which derives an estimated value for a company by reference to the market trading multiples of comparable publicly-listed companies.

Other than the Company, there is no passenger rail company listed on the Stock Exchange. We have evaluated rail companies listed on other international stock exchanges which are of comparable size to KCRC. We have not found a listed passenger rail company that controls a metropolitan rail network comparable to the KCRC System.

In addition, the Rail Merger is structured as a Service Concession (which is similar to a lease arrangement), with various unique and significant features for which comparable precedents are difficult to establish, including but not limited to:

(i) no assumption of KCRC's existing debt (except in relation to the CBLs) by the Company;

(ii) the Company being able to access and operate KSL without the need to incur capital expenditure required for its construction; and

(iii) the Variable Annual Payments being directly linked to the revenue attributable to the KCRC System in the future.

For these reasons, we do not consider it appropriate to use either comparable acquisition analysis or comparable trading analysis to evaluate the Rail Merger from a financial point of view.

**(b) Value Implications of Adopting the Fare Adjustment Mechanism**

According to the Letter from the Board contained in the Circular, at present, both the Company and KCRC have fare autonomy, and they set their fares in accordance with prudent commercial principles having regard to prevailing market conditions, competition from other transport modes and their respective financial objectives. According to MTRC's prospectus for its privatisation share offer in 2000, MTRC has always enjoyed fare autonomy since it began operating railway services in 1979, even before it became a publicly traded company in 2000. Historically, under previous operating agreements, the Company had to comply with a specified procedure before changing the level of any fare, including:

(i) considering the level of public acceptance of any proposed change (based on passenger surveys);

(ii) consulting with the Transport Advisory Committee and the Legislative Council Panel on Transport and notifying them within a reasonable period prior to the implementation of a new fare; and

(iii) making a public announcement of a new fare.

One of the parameters of the Rail Merger set by the Government in February 2004 was the adoption of a more objective and transparent fare adjustment mechanism. To address this requirement, the Company and the Government have agreed upon a formulaic approach for determining future fare adjustments to replace fare autonomy after the Rail Merger. After the completion of the Rail Merger, the Company is to adopt a "direct-drive" fare adjustment formula to determine fare levels for all the existing and new railway lines that it operates (with the exception of certain lines, including the Airport Express).

Prescribed fares will be reviewed annually according to the following direct-drive formula for the Fare Adjustment Mechanism or FAM:

Overall weighted fare adjustment rate = 0.5 x $\Delta$ CCPI + 0.5 x $\Delta$ wage index - t

where:

(i) "Overall weighted fare adjustment rate" is calculated on the basket of specified "fares" on the Integrated Railway;

(ii) "$\triangle$ CCPI" means the yearly percentage change in the Government Composite Consumer Prices Index ("**CCPI**");

(iii) "$\triangle$ wage index" means the yearly percentage change in the Nominal Wage Index (Transport Services Sector) ("**Wage Index**"); and

(iv) "t" is a productivity factor. The purpose of "t" is to incentivise the Company to achieve productivity gains. "t" will be deemed to be zero in the first 5 years following the Merger Date. "t" will have a value of 0.1% starting from the sixth year following the Merger Date. The value of "t" will not be subject to review until after the ninth anniversary of the Merger Date under the agreed review mechanism for the FAM. If the Company keeps its fare related costs at the rate of inflation set out in the above formula, "t" (as from the sixth year following the Merger Date) will result in the Company's fare revenue increasing at a level less than the inflation rate. This will reduce the Company's real rate of return (being revenue less costs, after taking into account such inflation rate). "t" therefore acts as an incentive for the Company to achieve productivity gains in order to ensure its real rate of return does not diminish.

The FAM will be subject to review every 5 years upon request by either the Government or the Company. Any fare adjustment under the FAM which is between +1.5% and -1.5% (inclusive) in a particular year can be carried over to the next year. The Company also has the right to adjust certain individual fares within a range of +5.0% and -5.0% from the overall weighted fare adjustment rate under certain circumstances.

### *Evaluation Methodology for the FAM*

To determine whether such change in fare setting policy will positively or negatively affect MTRC, we have adopted a retrospective analysis to examine what the hypothetical fare level and the year-on-year fare increase for MTRC would have been if the FAM had been adopted historically.

Whilst we note that historical data is not necessarily predictive of the future, we are of the view that this method provides a reasonable basis to evaluate the long term impact of the FAM given the relatively steady business nature of the rail operations of MTRC and KCRC.

As part of our analysis, we have considered:

(i) the annual percentage changes of CCPI data from 1983 to 2006;

(ii) the annual percentage changes of Wage Index data from 1983 (being the earliest date for which such data is available) to 2006; and

(iii) the historical announced fare changes of MTRC as disclosed in its annual fare change press releases from 1984 to 1997. MTRC has not announced any fare change since 1997.

We have then calculated the hypothetical fare changes based on the FAM formula from 1984 to 2007 (a period of 24 years) and compared these figures to the actual, historical fare changes of MTRC to evaluate the illustrative long term effect of the FAM, for each year and on a cumulative basis. We have assumed that the productivity factor was nil for the illustrative evaluation period.

We set out in Table 6 below the calculated hypothetical FAM fare changes and the comparable actual, historical fare changes of MTRC from 1984 to 2007 inclusive:

**Table 6**

***Annual Fare Changes Based on Retrospective Application of FAM Relative to Changes in Indices and Historical MTRC Fare Changes (1984-2007)***

| Year of Fare Change Evaluated/ Announced | Reference Period | Change in CCPI Level (%)(1) | Change in Wage Index Level (%)(2) | Theoretical Level of Fare Increase under FAM (%)(3) | Announced Historical Fare Increase (%)(4) |
|---|---|---|---|---|---|
| 1984 | Dec. 1982 - Dec. 1983 | 10.90% | 8.80% | 9.85% | 15.00% |
| 1985 | Dec. 1983 - Dec. 1984 | 5.30% | 10.70% | 8.00% | 3.50% |
| 1986 | Dec. 1984 - Dec. 1985 | 3.10% | 9.80% | 6.45% | 5.00% |
| 1987 | Dec. 1985 - Dec. 1986 | 4.60% | 8.00% | 6.30% | 6.70% |
| 1988 | Dec. 1986 - Dec. 1987 | 7.40% | 8.30% | 7.85% | 7.30% |
| 1989 | Dec. 1987 - Dec. 1988 | 8.30% | 11.80% | 10.05% | 9.30% |
| 1990 | Dec. 1988 - Dec. 1989 | 10.10% | 18.10% | 14.10% | 9.50% |
| 1991 | Dec. 1989 - Dec. 1990 | 11.30% | 14.00% | 12.65% | 11.00% |
| 1992 | Dec. 1990 - Dec. 1991 | 9.90% | 13.70% | 11.80% | 9.70% |
| 1993 | Dec. 1991 - Dec. 1992 | 9.60% | 12.10% | 10.85% | 9.00% |
| 1994 | Dec. 1992 - Dec. 1993 | 9.00% | 10.80% | 9.90% | 7.10% |
| 1995 | Dec. 1993 - Dec. 1994 | 9.50% | 10.60% | 10.05% | 7.82% |
| 1996 | Dec. 1994 - Dec. 1995 | 7.20% | 6.70% | 6.95% | 6.90% |
| 1997 | Dec. 1995 - Dec. 1996 | 6.60% | 7.00% | 6.80% | 5.50% |
| 1998 | Dec. 1996 - Dec. 1997 | 5.20% | 7.00% | 6.10% | 0.00% |
| 1999 | Dec. 1997 - Dec. 1998 | (1.60%) | 4.30% | 1.35% | 0.00% |
| 2000 | Dec. 1998 - Dec. 1999 | (4.00%) | (1.60%) | (2.80%) | 0.00% |
| 2001 | Dec. 1999 - Dec. 2000 | (2.10%) | (2.40%) | (2.25%) | 0.00% |
| 2002 | Dec. 2000 - Dec. 2001 | (3.60%) | 2.00% | (0.80%) | 0.00% |
| 2003 | Dec. 2001 - Dec. 2002 | (1.50%) | 0.50% | (0.50%) | 0.00% |
| 2004 | Dec. 2002 - Dec. 2003 | (1.90%) | (2.60%) | (2.25%) | 0.00% |
| 2005 | Dec. 2003 - Dec. 2004 | 0.20% | (1.10%) | (0.45%) | 0.00% |
| 2006 | Dec. 2004 - Dec. 2005 | 1.30% | 1.40% | 1.35% | 0.00% |
| 2007 | Dec. 2005 - Dec. 2006 | 2.30% | 0.40% | 1.35% | 0.00% |
| **Average Increase** | | **+4.46%** | **+6.60%** | **+5.53%** | **+4.72%** |
| **Cumulative Increase** | | **+177.50%** | **+347.35%** | **+253.43%** | **+196.01%** |

*Source: Census and Statistics Department of Hong Kong and the Company's press releases.*

*(1) Based on statistics collected in December of each year.*

*(2) Based on statistics collected in December of each year, except for 1989-1999 where December data was unavailable. Instead, September data was used.*

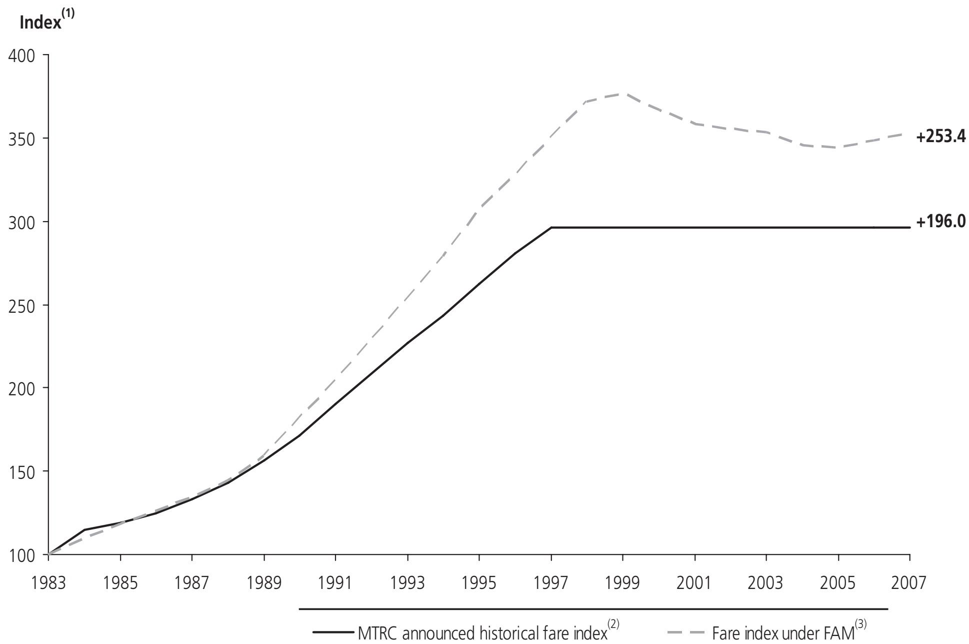
*(3) Under the FAM, adjustments not applied in any year, as a result of being below the ±1.5% threshold, would be carried over to be applied to the following year's FAM calculation. For comparison purposes, we have not adopted such provision in our analysis.*

*(4) Based on MTRC's announced fare changes and excludes Airport Express.*

Chart 2 below shows the cumulative effect of the hypothetical FAM fare changes relative to the actual, historical announced fare changes of MTRC under fare setting autonomy shown in Table 6 above from 1984 to 2007 inclusive.

**Chart 2**

***Annual Fare Changes Based on Retrospective Application of FAM Relative to Historical MTRC Fare Changes (1983-2007)***




*Source: Census and Statistics Department of HKSAR and Company press releases.*

*(1) Re-based to 100 in 1983.*

*(2) Based on MTRC's announced fare changes and excludes Airport Express.*

*(3) Under the FAM, adjustments not applied in any year, as a result of being below the ± 1.5% threshold, would be carried over to be applied to the following year's FAM calculation. For comparison purposes, we have not adopted such provision in our analysis.*

***Key Observations of Retrospective Analysis***

Based on our discussions with the management of the Company, and as set out in the Letter from the Board contained in the Circular, we note that the Company is of the view that the FAM gives it a measure of certainty with respect to its fares. The Company therefore considers that the FAM will be beneficial to the Company particularly in the long term.

We note that, on a retrospective basis, the FAM would have led to a higher cumulative fare level in 22 out of the past 24 years, and for every year since 1986. On average, fares would have increased by 5.53% per annum based on FAM, as compared to 4.72% based on the actual, historical fare changes. On a cumulative basis, the hypothetical FAM fare level would have increased by approximately 253.4% as compared to approximately 196.0% based on the actual, historical fare changes. We also note that the change in Wage Index was higher than the change in CCPI for 18 out of the past 24 years. As such the FAM fare, with a 50% contribution from the Wage Index, would generally be expected to outperform inflation (as measured by the CCPI).

We observe that the only period when the FAM fare changes consistently underperformed the actual fare changes was between 2000 and 2005, an unprecedented deflationary period in Hong Kong. We view this period as an exceptional period in Hong Kong's history. As noted earlier, based on its 2007-2008 budget, the Government has projected real GDP growth, which is generally closely linked to CCPI growth, of 4.5% per year between 2008 and 2011. In addition, according to the Economic Intelligence Unit, a third party economic research and advisory firm, the average CCPI growth of Hong Kong between 2008 and 2030 is expected to be approximately 2.4% per annum.

### (c) Variable Annual Payment Mechanism and Impact of Inflation and Deflation

Based on the assumptions set out above, our net present value analysis in section 9.(a) has determined that the Service Concession and the Purchased Rail Assets are expected to be value accretive to MTRC assuming steady-state incremental cashflows, meaning zero nominal growth over the entire 50-year illustrative Concession Period, even if synergies are excluded.

The Variable Annual Payment mechanism is one of the key drivers of the total consideration to be paid by MTRC to KCRC over the Concession Period and is the only element of the total consideration that is variable and therefore susceptible to change during periods of inflation or deflation. We note that the Variable Annual Payment mechanism does not, however, adjust for inflation or deflation. With inflation in any given year of the Concession Period, revenues will increase, but the revenue sharing thresholds will remain fixed, resulting in an increased absolute amount of Variable Annual Payment as inflation increases.

We have therefore evaluated the Variable Annual Payment mechanism separately to determine its potential impact on the overall economic value of the Service Concession and the Purchased Rail Assets. We have focused specifically on the impact of periods of inflation or deflation on the calculation of the Variable Annual Payment, and the resultant impact on the likely economic value of the Service Concession and the Purchased Rail Assets as a whole.

***Variable Annual Payment***

As detailed in the Letter from the Board contained in the Circular, the Variable Annual Payment for the Service Concession will be calculated as a percentage of revenue generated from the KCRC System for each financial year.

The applicable percentage will vary according to the amount of revenue from the KCRC System for the relevant financial year of the Company as follows:

(i) for the first HK$2.5 billion of revenue from the KCRC System, the applicable percentage will be 0.0%;

(ii) for the next HK$2.5 billion, the applicable percentage will be 10.0%;

(iii) for the next HK$2.5 billion, the applicable percentage will be 15.0%; and

(iv) for the revenue from the KCRC System above the first HK$7.5 billion, the applicable percentage will be 35.0%.

The Variable Annual Payment will be payable annually in arrears within 60 days after the end of the relevant financial year of the Company (and will be adjusted if, following finalisation of the Company's audited accounts, the amount paid by the Company within the 60-day period referred to above is not correct). No Variable Annual Payment shall be payable in respect of the first 36 months following the Merger Date.

***Fixed Annual Payment***

The Fixed Annual Payment amounts to HK$750 million per annum for the duration of the Service Concession. We note that while the Variable Annual Payment, as a percentage of revenue generated from the KCRC System, will increase with rising revenues, the Fixed Annual Payment, as a percentage of revenue generated from the KCRC System, will continue to decrease over the Concession Period.

### *Calculation of KCRC System Net Cash Margin*

Based on our discussions with the management of the Company, we understand that the KCRC System net cash margin is defined as follows:

$$\text{KCRC System net cash margin} = \frac{\text{(KCRC System EBITDA - Variable Annual Payment - Fixed Annual Payment - KCRC System capital expenditure)}}{\text{KCRC System revenues}}$$

where "**EBITDA**" is defined as earnings before interest, tax, depreciation and amortisation.

Based on our discussions with the management of the Company, we understand that the pre-tax incremental cashflows directly related to the KCRC System attributable to MTRC for any given year are equal to the KCRC System revenues multiplied by the KCRC System net cash margin:

$$\text{Incremental cashflow to MTRC from the KCRC System} = \text{(KCRC System revenues x KCRC System net cash margin)}$$

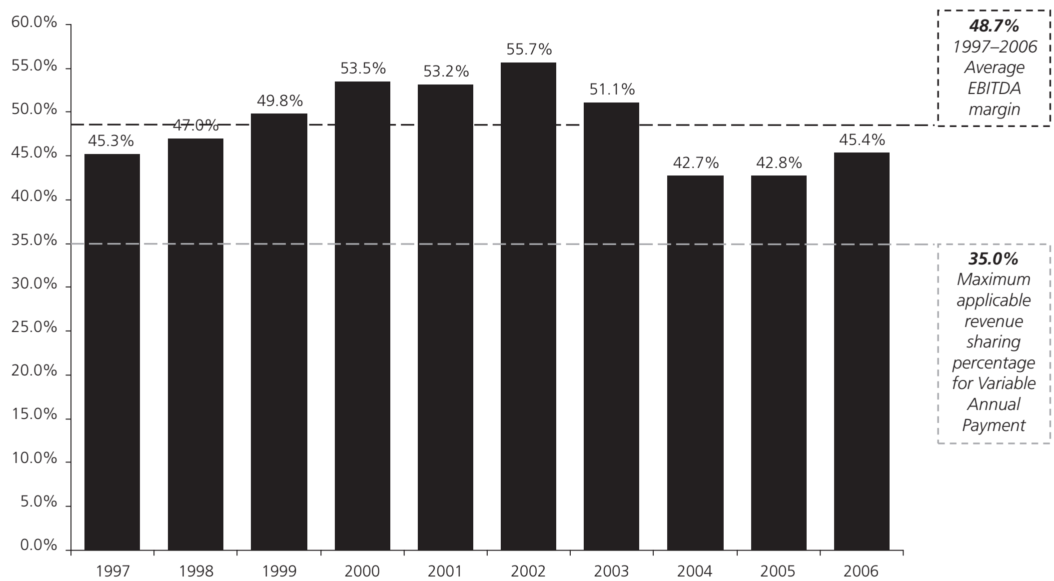
The Variable Annual Payment and the Fixed Annual Payment are key components of the net cash margin of the KCRC System over the Concession Period. By making assumptions about the KCRC System net cash margin in any given year, we can estimate the illustrative, incremental cashflows directly related to the KCRC System attributable to MTRC for that year, based on the assumptions adopted.

### *Historical KCRC System EBITDA Margin*

We set out in Chart 3 below the estimated historical EBITDA margins for the KCRC System for the period 1997 to 2006 which have been supplied to us by KCRC.

**Chart 3**

***Historical KCRC System EBITDA Margin (1997-2006)***




*Source: Estimated KCRC figures provided by KCRC to MTRC. Fiscal year ended 31 December.*
*Note: We understand that the estimated KCRC System EBITDA includes allocated KCRC corporate expenses and excludes certain one-off items.*

Based on our discussions with the management of the Company, we have assumed that the period from 1997 to 2006 is representative of the long-term, future profitability of the KCRC System and can therefore reasonably be used as a reference in our analysis.

We note the following on the estimated historical EBITDA margins of the KCRC System:

(i) KCRC System's estimated EBITDA margin increased from approximately 45.3% in 1997 to approximately 55.7% in 2002, then decreased to approximately 42.7% in 2004, and rose to approximately 45.4% in 2006;

(ii) the average estimated KCRC System's EBITDA margin for the period considered was approximately 48.7%; and

(iii) KCRC System's estimated EBITDA margin was depressed from 2004 to 2006, due to the introduction of new lines (primarily West Rail and MOS Rail), as new rail extensions typically require a few years to complete their initial ramp-up phase for revenues. Whilst new rail extensions are also planned in future years post the Merger Date, we understand from the Company that these extensions are expected to become profitable in a much shorter timeframe than the new rail extensions that were introduced between 2004 and 2006.

***Potential Impact of the FAM on the KCRC System Margin***

As part of our review of the impact of the Variable Annual Payment mechanism on KCRC System's EBITDA margin, we have also taken into account the potential impact of the FAM.

We note that since 1983 (being the earliest year for which such data is available), the change in the Wage Index was higher than the change in CCPI for 18 out of the past 24 years (refer to section 9.(b) titled "Value Implications of Adopting the Fare Adjustment Mechanism" above). In a steady-state scenario with the FAM, if the change in Wage Index continues to be higher than the change in CCPI, revenues could be expected to grow faster than inflation.

Furthermore, if this relationship between the change in Wage Index and the change in CCPI continues to hold true (i.e. the change in Wage Index continues to be higher than the change in CCPI in most years of the Concession Period), given that revenues are only adjusted by 50% of the change in the Wage Index (based on the FAM formula), but wage costs are likely to be impacted by 100% of the change in the Wage Index, we would expect the EBITDA margin to remain constant or actually increase during the Concession Period as long as wage costs for the KCRC System represent less than 50% of the total cash operating costs.

Based on our review of relevant KCRC historical data supplied to us by the Company, we understand that KCRC System's wage costs have historically been less than 50% of total cash operating costs. If this relationship continues to apply over the entire Concession Period (i.e. the KCRC System's wage costs remain below 50% of the total cash operating costs of the KCRC System), we would expect the EBITDA margin to remain constant or increase in an inflationary scenario. However, if wage costs increase to more than 50% of the total cash operating costs of the KCRC System, the KCRC System EBITDA margin could potentially decrease over the Concession Period.

We have assumed that the productivity factor of the FAM formula does not have a significant impact on KCRC System's EBITDA margin. We note that the Company and the Government have agreed that the productivity factor shall be zero for the first 5 years following the Merger Date, and 0.1% thereafter. We also note that the productivity factor will not be subject to review until after the ninth anniversary of the Merger Date under the agreed review mechanism of the FAM.

***KCRC System Capital Expenditure Margin***

As set out in Appendix VII, "Financial Information of the Enlarged Group", contained in the Circular, the incremental capital expenditure for the KCRC System for 2006 was HK$389 million, representing approximately 8.1% of KCRC System's revenues for 2006, after taking into account the one-off fare reduction of HK$600 million.

We note that, assuming steady-state operations, with any growth in revenues and costs directly linked to inflation, we would expect the capital expenditure margin of the KCRC System to remain relatively constant from year 2 until the end of the illustrative Concession Period (we have assumed a conservative 2-year fare freeze, resulting in an increasing KCRC System capital expenditure margin for the first 2 years in an inflation scenario).

***Valuation Methodology and Key Assumptions to Assess Impact of Inflation on the KCRC System Variable Annual Payment Margin***

To determine the likely impact of the Variable Annual Payment mechanism on the value of the Service Concession and the Purchased Rail Assets, we have used the same illustrative net present value methodology as for the Service Concession and the Purchased Rail Assets outlined above in section 9.(a) of this letter.

The key assumptions and calculations made in our illustrative analysis of the net present value impact of the Variable Annual Payment, and the effect of periods of inflation are as follows:

(i) to illustrate the effects of inflation on the Variable Annual Payment, we have assumed a range of inflation rates of 3.0% to 7.0% per annum for the entire illustrative 50-year Concession Period. This is purely for illustrative purposes. The average inflation rate in Hong Kong since 1981, being the earliest year for which inflation data is publicly available, has been approximately 5.03%. We note that, based on its 2007-2008 budget, the Government projects real GDP growth, which is generally closely linked to CCPI growth, of 4.5% per annum between 2008 and 2011. In addition, according to the Economic Intelligence Unit, the average CCPI growth of Hong Kong between 2008 and 2030 is expected to be approximately 2.4% per annum;

(ii) in line with our methodology adopted in section 9.(a) of this letter to calculate the illustrative net present value of the Service Concession and the Purchased Rail Assets, we have assumed steady-state operations, with any change in revenues and costs directly linked only to the rate of assumed inflation and we have excluded synergies;

(iii) we have used KCRC System figures for the financial year ended 31 December 2006 to project illustrative revenues and calculate illustrative Variable Annual Payments over the Concession Period based on our assumptions. We have used the 2006 KCRC System revenue figure as a base year, with an illustrative Concession Period starting on 1 January 2008;

(iv) we have adjusted the 2006 KCRC System revenue to reflect the one-off fare reduction of HK$600 million, as detailed in the Letter from the Board contained in the Circular;

(v) we have taken the KCRC System's average EBITDA margin of approximately 48.7% for the 10-year period from 1997 to 2006 and adjusted for the one-off fare reduction of HK$600 million (which we have assumed as a full deduction to the KCRC System EBITDA with no corresponding cost relief). We have assumed that the resultant adjusted EBITDA margin (the "**Adjusted KCRC System EBITDA Margin**") remains constant for the entire illustrative Concession Period;

(vi) we have assumed a conservative, 2-year fare freeze until 31 December 2009 (the actual fare freeze is only expected to be in effect until June 2009);

(vii) we have assumed that the KCRC System's wage costs will remain below 50% of the total cash operating costs of the KCRC System throughout the Concession Period. In this situation, we would expect the Adjusted KCRC System EBITDA Margin to remain constant or increase in an inflationary scenario. To be conservative, we have further assumed that the Adjusted KCRC System EBITDA Margin remains constant (with no margin improvement) over the entire illustrative Concession Period;

(viii) we have assumed that the incremental KCRC System capital expenditure will be subject to inflation throughout the illustrative Concession Period in line with our overall illustrative inflation assumptions;

(ix) consistent with the methodology adopted in section 9.(a) of this letter, based on our discussions with the management of the Company, we have assumed a 30.0% depreciation tax-allowance on the KCRC System capital expenditure, and we have fully tax-effected the resultant, incremental pro-forma pre-tax cashflows at the Hong Kong corporate tax rate of 17.5% for each year of the illustrative Concession Period; and

(x) we have assumed that all the incremental adjusted cashflows for the KCRC System would be received on 30 June of each respective year during the illustrative Concession Period in order to calculate the illustrative, net present value of the adjusted, incremental cashflows for the KCRC System at an estimated inflation-adjusted WACC for MTRC.

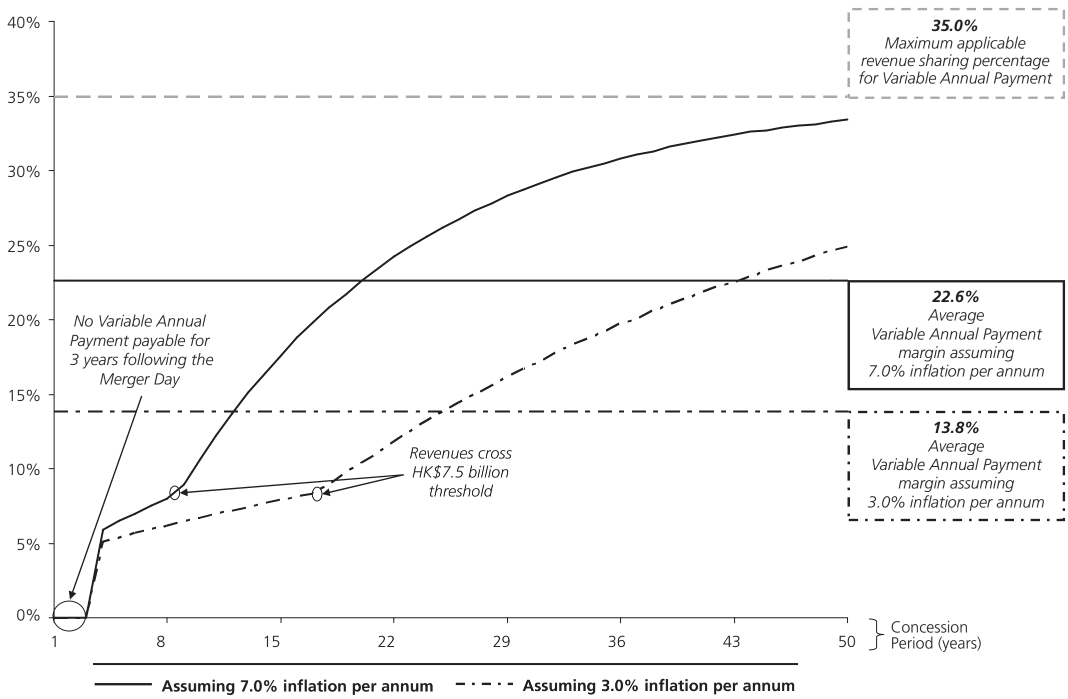
We have discounted all the incremental, post-tax, inflation-adjusted KCRC System cashflows (the "**KCRC System Inflation Cashflows**") to 1 January 2008, being our assumed Merger Date.

***Impact of Inflation on the KCRC System Variable Annual Payment Margin***

We set out in Chart 4 below the illustrative Variable Annual Payment margin, assuming an inflation range of 3.0% to 7.0% per annum over the illustrative 50-year Concession Period, and based on the methodology and assumptions set out above.

**Chart 4**

***Illustrative KCRC System Variable Annual Payment Margin — Assuming Inflation of 3.0% and 7.0% Per Annum***




***Key Assumptions***

1. *We have assumed KCRC System's adjusted 2006 figures as a base year for the start of the Concession Period, with an illustrative Concession Period starting on 1 January 2008 for 50 years.*
2. *We have assumed inflation of 3.0% and 7.0% per annum.*
3. *Given the FAM, inflation of 3.0% or 7.0% per annum could result in revenues growing faster or slower than 3.0% or 7.0% depending on the change in the Wage Index and the productivity factor. For simplicity, in our analysis, we have assumed a constant 3.0% or 7.0% increase in revenues year-on-year.*

We note that, based on our illustrative analysis, assuming inflation of 7.0% per annum, the average Variable Annual Payment margin is approximately 22.6% over the illustrative Concession Period, and 13.8% assuming inflation of 3.0% per annum over the illustrative Concession Period. We further note that the Variable Annual Payment margin in each scenario remains below 35.0% during the entire illustrative Concession Period.

On the basis of this analysis and the assumptions adopted, we conclude that the average Variable Annual Payment margin should remain below 35.0% during the entire illustrative Concession Period based on reasonable expectations of future inflation in Hong Kong during such period.

***Net Present Value Analysis of KCRC System Inflation Cashflows Excluding Synergies***

We have calculated the illustrative, net present value of the KCRC System Inflation Cashflows, calculated based on the methodology and assumptions outlined above, assuming a range of inflation rates of 3.0% to 7.0% per annum for the entire illustrative Concession Period as set out in Table 7 below.

**Table 7**

***Illustrative Net Present Value of KCRC System Inflation Cashflows Excluding Synergies — Assuming a Range of Inflation Rates of 3.0% to 7.0% per Annum for the Illustrative Concession Period***

| | Assumed Inflation Rate per Annum for the Illustrative Concession Period | | | | |
|---|---|---|---|---|---|
| | | | **Average Hong Kong Inflation Rate (1981-2006)** | | |
| | 3.0% | 4.0% | **5.0%** | 6.0% | 7.0% |
| Estimated inflation-adjusted WACC (1) | 9.8% | 10.8% | **11.9%** | 12.9% | 13.9% |
| Illustrative net present value of KCRC System Inflation Cashflows based on inflation-adjusted WACC (HK$mm) | 2,624 | 2,005 | **1,387** | 838 | 320 |

(1) *We have adjusted our calculation of MTRC's cost of equity and cost of debt (as outlined in Table 3 above) by first estimating the real costs of equity and debt of MTRC (assuming the rates reflect an embedded inflation of 2.3%, which was the inflation rate in Hong Kong in 2006), and we have then estimated the revised nominal rates based on our assumed range of inflation rates of between 3.0% and 7.0%.*

Based on the assumptions set out above, in a scenario of inflation of 5.0% per annum for the entire 50-year illustrative Concession Period (being the approximate average inflation rate in Hong Kong between 1981 and 2006), our illustrative analysis implies that the KCRC System Inflation Cashflows for the illustrative Concession Period have an illustrative positive net present value of approximately HK$1,387 million, even after taking into account the expected one-off fare reduction of HK$600 million and a 2-year fare freeze.

We note that, assuming inflation of 7.0% per annum for the entire 50-year illustrative Concession Period, the illustrative net present value is still positive, with an illustrative net present value of approximately HK$320 million.

***We also note that the above analysis does not take into account the estimated synergies that the Company expects to realise from the Rail Merger, which are separately discussed below in section 9.(e) of this letter. We further note that, in periods of inflation, the quantum of synergies would generally be expected to grow in line with inflation.***

The above illustrative net present value analysis is dependent on the underlying assumptions adopted. The final outcome could be better or worse than our purely illustrative analysis depending, in particular, on the actual incremental rail and related cashflows of the KCRC System in comparison to our illustrative calculations of the KCRC System Inflation Cashflows.

We also note that this analysis could be impacted by the following:

(i) the actual future KCRC System's EBITDA margin may be lower than our Adjusted KCRC System EBITDA Margin assumption over the Concession Period due to factors such as increasing competition from other modes of transportation, particularly for KCRC's cross-boundary business, which accounted for approximately 47% of KCRC's fare revenue in 2006 (the potential impact of this is considered in more detail below in section 9.(d) of this letter);

(ii) as explained below in section 9.(c) of this letter titled "Potential Impact of the FAM on the KCRC System EBITDA Margin," due to the structure of the FAM, there could be a negative impact on the Adjusted KCRC System EBITDA margin and the net cash margin if wage costs represent more than 50% of the total cash operating costs of the KCRC System over the Concession Period; and

(iii) the KCRC System capital expenditure margin could increase over the Concession Period, negatively impacting the KCRC System net cash margin.

***Impact of Deflation***

As part of our analysis, we have also looked at the impact of periods of deflation. Following the same methodology and other assumptions as outlined above, we note that it would take deflation of close to 3% per annum over the entire 50-year illustrative Concession Period for the illustrative net present value of the KCRC System to be negative. We note that Hong Kong has experienced deflation in only 6 of the past 26 years. As discussed above, based on forecast data for CCPI that is currently available and historical trends in CCPI change in Hong Kong, we believe that it is highly unlikely that Hong Kong will experience year-on-year deflation over the entire 50-year Concession Period.

### (d) Impact of Increasing Competition on KCRC's Cross-boundary Business

We note that although KCRC is the only rail operator providing passenger and freight rail services between Hong Kong and the Mainland, its services face competition from other transport providers, primarily buses and ferries. In addition, the opening of the Hong Kong-Shenzhen Western Corridor to the public on 1 July 2007 may potentially increase the level of competition faced by KCRC which may in turn adversely affect KCRC's revenue growth and profit margin over the Concession Period.

However, we also note that, according to the "Industry Background" section and the "Information on the Business of KCRC" section in the Circular, rail is still the predominant mode of cross-boundary transportation and accounted for approximately 55% of the total cross-boundary market (excluding air traffic) in 2006. In addition, according to the Railway Development Strategy 2000 as formulated by the Government in May 2000, cross-boundary demand is forecasted to increase by over 3 times by 2016.

We also note that the Variable Annual Payment structure could potentially provide certain downside protection for the Company over the Concession Period. In the event that the expanding cross-boundary demand is not sufficient to compensate for the revenue erosion due to increasing competition, the Company's obligation under the Variable Annual Payment structure will also decrease correspondingly, thereby partially compensating for the reduced operating cashflow from the KCRC System.

### (e) Value Implications of the Potential Annual Synergies

***Valuation Methodology and Key Assumptions***

It is stated in the Letter from the Board contained in the Circular that the Company expects the Rail Merger to create annual, pre-tax synergies of up to HK$450 million once fully implemented, which is expected to be within 3 years of the Merger Date. Based on our discussions with the management of the Company and its advisers and our review of relevant documents supplied to us by the Company, we believe that it is reasonable to assume that the Company's estimate of synergies that will arise from the Rail Merger has been prepared by the Company with due care and consideration.

To determine the potential value of the pre-tax synergies that the Company estimates will be created from the Rail Merger, we have used the same illustrative, net present value methodology as for the Service Concession and the Purchased Rail Assets outlined above in section 9.(a) of this letter.

The key assumptions and calculations made in our illustrative analysis of the net present value of the potential annual synergies are as follows:

(i) based on our discussions with the management of the Company, we have assumed that: (i) approximately 33.3% of the annual pre-tax full synergies of HK$450 million or HK$150 million would be realisable in year 1 of the Rail Merger; (ii) approximately 66.7% in year 2 (HK$300 million); and (iii) 100.0% (HK$450 million) from year 3 onwards until the end of the illustrative Concession Period (the "**Zero Growth Case Synergies**");

(ii) in line with our prior methodology to calculate the net present value of the Service Concession and the Purchased Rail Assets, we have assumed steady-state operations for the entire illustrative Concession Period, with zero nominal growth in the Zero Growth Case Synergies;

(iii) also in line with our prior methodology, we have fully tax-effected the Zero Growth Case Synergies at the Hong Kong corporate tax rate of 17.5% for each year of the 50-year illustrative Concession Period;

(iv) we have assumed total one-time costs to achieve the Zero Growth Case Synergies of HK$1.35 billion, representing 3 times the Company's estimated annual pre-tax full synergies of HK$450 million (we believe this cost assumption is conservative based on our discussions with the management of MTRC), and we have assumed that such one-time costs would be spread evenly over the first 3 years of the Concession Period (HK$450 million per year, with no tax deduction assumed for these costs); and

(v) we have assumed that all the cashflows outlined above would be received on 30 June of each respective year during the illustrative Concession Period in order to calculate the illustrative net present value of the cashflows outlined above using our estimation of MTRC's WACC, which we believe can reasonably be used as a proxy for the risks associated with implementing the Rail Merger and realising the expected synergies.

We have discounted the resultant, tax-effected Zero Growth Case Synergies (the "**Adjusted Zero Growth Case Synergy Cashflows**"), and the costs to achieve the illustrative Zero Growth Case Synergies to 1 January 2008, being the assumed merger date for the purpose of our illustrative analysis.

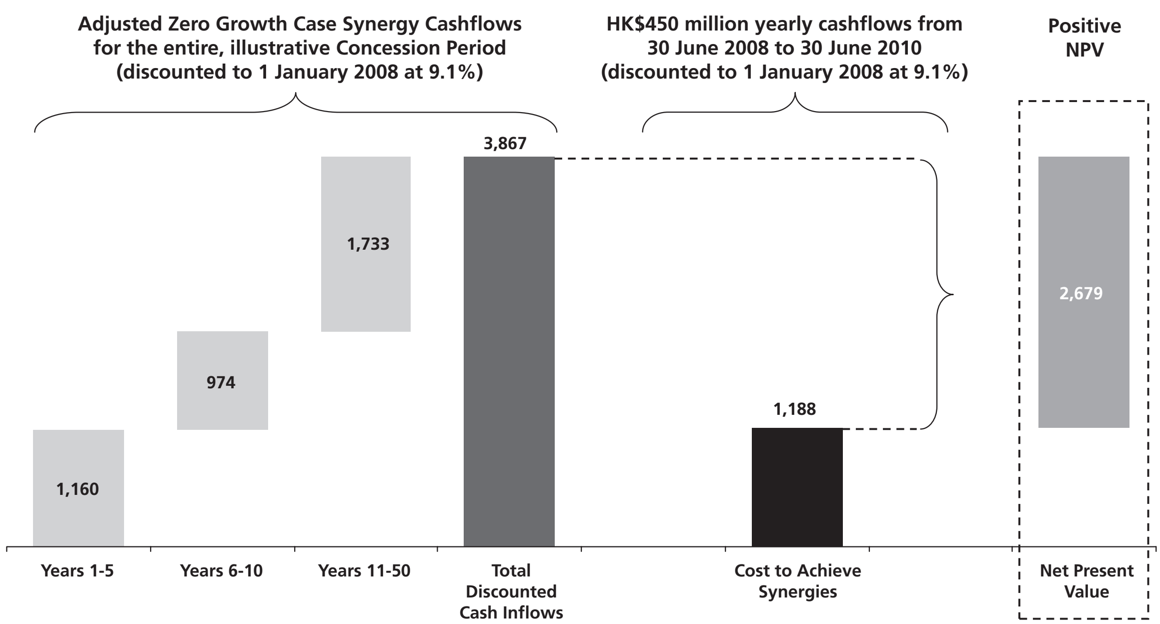
***Net Present Value of Adjusted Zero Growth Case Synergy Cashflows***

We set out in Chart 5 below the net present value calculation of the illustrative Adjusted Zero Growth Case Synergy Cashflows, and the costs to achieve the Zero Growth Case Synergies, calculated based on the methodology and assumptions outlined above.

**Chart 5**

***Illustrative Net Present Value of Adjusted Zero Growth Case Synergy Cashflows***

***(HK$ in millions)***




Based on the assumptions set out above, our illustrative analysis implies that the Adjusted Zero Growth Case Synergy Cashflows for the illustrative Concession Period have an illustrative positive net present value of approximately HK$2,679 million.

We note that, in our illustrative analysis, due to the time value of money, the Adjusted Zero Growth Case Synergy Cashflows for the initial years of the Concession Period account for much of the total value, with the Adjusted Zero Growth Case Synergy Cashflows realised in years 1 to 5 of the illustrative Concession Period accounting for approximately 30% of the value of the total discounted cash inflows.

The above net present value analysis is illustrative only and depends on the underlying assumptions of our analysis. The final outcome could be better or worse than our illustrative analysis depending in particular on the actual synergies achieved from the Rail Merger, and the actual costs incurred to achieve such synergies.

We believe that our analysis and assumptions as stated above are conservative for the following reasons:

(i) we have assumed significant costs of HK$1.35 billion to realise the full synergies, which we believe to be in excess of the expected costs required to achieve such synergies based on our discussions with the management of MTRC;

(ii) we have fully tax-effected the Zero Growth Case Synergies in each year of the illustrative Concession Period at the Hong Kong corporate tax rate of 17.5%, which does not account for tax deductions that may be available to MTRC and its substantial accumulated tax losses brought forward;

(iii) we have not assumed any tax deductions from the costs to be incurred to achieve the synergies; and

(iv) our calculated WACC for MTRC is a nominal rate which reflects a certain level of assumed inflation by the capital markets. In theory, this embedded inflation should be deducted from our estimation of the WACC, as we have assumed a zero growth cashflow scenario. In practice, it is not possible to estimate or calculate the precise level of future inflation assumed by the capital markets at any fixed point in time. However, making such a deduction would result in a lower discount rate and a higher net present value estimate.

***Sensitivity Analyses on the Net Present Value of the Adjusted Zero Growth Case Synergy Cashflows***

We have also undertaken sensitivity analyses on our Zero Growth Case Synergies, and on our estimate of the WACC as follows:

(i) we have considered the impact of the expected synergies being between 10.0% and 30.0% below or above the assumed Zero Growth Case Synergies of HK$450 million per annum (adjusted for costs with cost assumptions described above to achieve the expected synergies adjusted in line with the percentage increase/decrease assumed for the expected synergies, and tax as described above); and

(ii) we have considered the impact of a WACC range of between 9.0% and 11.0%.

For each scenario, we have calculated the net present value of the resultant cashflows.

We set out below in Table 8 the results of our sensitivity analyses on the illustrative net present value of the estimated full synergies expected by the Company from the Rail Merger.

**Table 8**

***Illustrative Net Present Value of Adjusted Zero Growth Case Synergy Cashflows — Sensitivity Analyses***

***(HK$ in millions)***

| | | Expected Annual Pre-Tax Synergies | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | *Assumed Percentage Decrease vs. Zero Growth Case* | | | **Zero Growth Case** | *Assumed Percentage Increase vs. Zero Growth Case* | | |
| | | (30.0%) | (20.0%) | (10.0%) | | +10.0% | +20.0% | +30.0% |
| **WACC** | 9.0% | 1,899 | 2,170 | 2,441 | **2,712** | 2,984 | 3,255 | 3,526 |
| | 9.5% | 1,763 | 2,015 | 2,267 | **2,518** | 2,770 | 3,022 | 3,274 |
| | 10.0% | 1,640 | 1,874 | 2,108 | **2,342** | 2,577 | 2,811 | 3,045 |
| | 10.5% | 1,528 | 1,746 | 1,964 | **2,182** | 2,401 | 2,619 | 2,837 |
| | 11.0% | 1,425 | 1,629 | 1,833 | **2,036** | 2,240 | 2,443 | 2,647 |

We note that, even assuming a discount rate of 11.0%, nearly 2.0% above our calculated WACC for MTRC of approximately 9.1%, and assuming annual pre-tax full synergies of HK$315 million (30.0% below MTRC's expected annual pre-tax full synergies of HK$450 million), with zero growth assumed for the entire 50-year illustrative Concession Period, the net present value is still positive, with a total illustrative net present value of approximately HK$1,425 million.

### (f) Property Package

***Overview***

As part of the Rail Merger, MTRC will purchase the Property Package from KCRC for a total consideration of HK$7.79 billion. The Property Package primarily includes KCRC's:

(i) Property development rights ("**KCRC Property Development Rights**");

(ii) Investment properties ("**KCRC Investment Properties**"); and

(iii) Management rights for certain KCRC properties ("**KCRC Management Rights**").

The Company has hired an independent property valuer, Jones Lang LaSalle, to value (i) and (ii) above. The detailed valuation report is included in Appendix VIII of the Circular.

***Valuation Methodologies and Assumptions to Assess Property Package***

According to the valuation report by Jones Lang LaSalle dated 3 September 2007 (the "**JLL Valuation Report**") set out in Appendix VIII to the Circular, the KCRC Investment Properties and KCRC Property Development Rights have been valued at HK$10,574 million as at 31 July 2007. This represents a pre-tax surplus of HK$2,824 million (HK$2,330 million post-tax assuming the effect of taxation at 17.5%) or 36.4% (30.1% post-tax) over the agreed consideration amount of HK$7.75 billion.

According to the JLL Valuation Report, and based on our discussions with Jones Lang LaSalle, the KCRC Investment Properties were valued on an open-market basis using primarily the income capitalisation method and the direct comparison method. The KCRC Property Development Rights were valued based on the present value of any estimated surplus proceeds to be shared by KCRC as a result of disposal or leasing of the development properties, which was assessed by adopting the discounted cashflow methodology, in accordance with the terms within the respective development agreements between KCRC and the developers as advised by the Company to Jones Lang LaSalle. The valuation methodologies are described in detail in the JLL Valuation Report.

We have discussed the valuation methodologies adopted and the principal assumptions made with Jones Lang LaSalle, including but not limited to the rental assumptions for the KCRC Investment Properties, the capitalisation rate that was applied, sales price assumptions for the KCRC Property Development Rights and cost of capital assumptions. We have also confirmed with Jones Lang LaSalle and the management of MTRC that the Property Package is in reasonable condition and that there are no major renovations or refurbishments that need to be undertaken for any of the properties within the Property Package. As such, the management of MTRC have confirmed to us that no significant capital expenditure is expected to be required in relation to the Property Package in the foreseeable future.

The Company will also acquire the KCRC Management Rights for HK$40 million. Based on our discussions with the management of MTRC, the consideration for such management rights were agreed upon based on arm's length negotiations with KCRC, having taken into account factors including the future cashflow potential of such management rights.

***Consistency with MTRC Business Strategy***

We note that the acquisition of the Property Package, which consists primarily of properties along the KCRC lines, is consistent with MTRC's Rail-and-Property Model. As stated in the Letter from the Board contained in the Circular, one of the key ingredients of the Company's success has been its Rail-and-Property Model. Further, according to the Letter from the Board contained in the Circular, this model has enabled the Company to develop properties and build communities along and adjacent to the railway. According to MTRC's annual reports, the Company's property business contributed 77.9%, 79.8% and 77.0% of the Company's operating income in 2004, 2005 and 2006, respectively.

***Enhancement of MTRC's Land Bank***

Upon completion of the Rail Merger, MTRC will hold one of the largest land bank of development properties in Hong Kong. As stated in the Letter from the Board contained in the Circular, the Company's development land bank (being development rights and property development interests in relation to which property development profits have not been accounted for up to 30 June 2007) will increase by 54.3% from 23.2m sq ft to 35.8m sq ft. The Property Package will also enable the development of properties along and adjacent to the MTRC Railway and the KCRC System to be managed in a co-ordinated manner. In addition, the current investment properties owned by the Company amount to approximately 2.7m sq ft gross and will increase to 3.6m sq ft gross after the opening of Phase I of Elements at Kowloon Station, which is scheduled to be in the fourth quarter of 2007. As a result of the Rail Merger, the investment properties owned by the Company would further increase by about 22% from 3.6m sq ft gross to 4.4m sq ft gross.

Based on our discussions with the management of MTRC, we understand that the acquisition of the economic benefits of the Property Package will enhance MTRC's economies of scale in its property business and strengthen its leverage and bargaining power when negotiating revenue sharing arrangements with developers. In addition, given the difficulties in acquiring land of significant size in Hong Kong, we are of the view that the acquisition economic benefits of the Property Package provides an attractive opportunity for MTRC to acquire more than 13m sq ft of investment and development properties in a single transaction, which we believe should be value accretive to the Company based on the JLL Valuation Report.

***Diversification of MTRC's Income Base***

The acquisition of the economic benefits of the Property Package not only will provide the Company with an increased land bank, but will also increase the recurrent income from the investment property portfolio and property management businesses. Revenue from investment properties and property management would increase by approximately 16.0% from HK$1,412 million to HK$1,638 million (based on an aggregation of the revenues of the Company and KCRC for the year ended 31 December 2006). In addition, the Company will take up KCRC's role as development agent for the Government in respect of the West Rail properties (which comprises a total gross floor area of about 24.3m sq ft). According to the Letter from the Board contained in the Circular, the Company will receive, in addition to cost recovery, from the West Rail Subsidiaries a fee of 0.75% of the gross sales proceeds in respect of the unawarded West Rail development sites (comprising approximately 22.7m sq ft gross floor area) and 10% of the relevant profits accrued to the West Rail Subsidiaries under the development agreements in respect of the awarded West Rail development sites (comprising approximately 1.6m sq ft gross floor area). This is expected to enhance further MTRC's non-fare, recurring income base.

***3-Year Rolling Programme***

We note that the Company and the Government have also agreed on a 3-year rolling programme for flat production arising from tender programmes for railway property development. We understand that the Government and the Company will discuss and draw up a 3-year rolling programme on an annual basis and that the first year of such 3-year rolling programme shall be binding on the Company. The agreed level of flat production will be revised as and when necessary, if mutually agreed by the Government and the Company. Based on our discussions with the management of the Company, such mechanism is aimed to ensure that there is an orderly process to coordinate the flat production and to preserve stability in the property market. We understand from the management of the Company that MTRC and KCRC have been liaising with the Government on an annual tender programme on a voluntary basis in the last few years. Therefore, the 3-year rolling programme under the Rail Merger, in particular the clause whereby the first year of such programme shall be binding on the Company, is mainly an attempt to formalise what is already the current practice of the Company and is unlikely to have any major impact on the Company's long-term flat production schedule and its ability to manage its property development business.

**(g) Financial Effects of the Rail Merger on MTRC**

In evaluating the Rail Merger, from a financial point of view, we have considered the financial effects of the Rail Merger on MTRC based on the information in the Letter from the Board contained in the Circular.

***Earnings***

It is stated in the Letter from the Board contained in the Circular that, as a result of the Rail Merger, there will be a significant increase to the revenue base of the Company. We note that the Company expects that such increase, together with the other benefits of the Rail Merger, will contribute to the accretion of EPS of the Company.

Assuming the Rail Merger had been effective on 1 January 2006, we note that the Company estimates that the 2006 pro-forma underlying EPS would have been HK$1.22, representing an increase of 13.0% when compared to the Company's reported EPS of HK$1.08 (before change in fair value of investment properties net of related deferred tax) for the 2006 financial year.

The accretion estimate of 13.0% relating to the 2006 pro-forma underlying EPS does not take into account: (i) the proposed fare reduction; (ii) the implementation of the FAM; (iii) the Variable Annual Payment (which is not required to be paid in respect of the first 36 months following the Merger Date); and (iv) the estimated full synergies. After taking into account all of the above, we note that the Directors also consider that the potential accretion over the Company's 2006 underlying EPS to be notable.

***Cashflow***

We note that the Company estimates in the Circular that the consolidated cash inflow from the operating activities of KCRC for the financial year 2006 would have been HK$2,719 million, representing an increase of approximately 50.5% over the Company's consolidated net cashflow generated from operating activities for the year ended 31 December 2006 of HK$5,387 million.

The estimated consolidated cash inflow from the operating activities of KCRC of HK$2,719 million does not take into account: (i) the Fixed Annual Payment; (ii) capital expenditure of HK$389 million to maintain and upgrade the KCRC System in the year ended 31 December 2006; (iii) the estimated proposed fare reduction; (iv) the estimated effect of the FAM; (v) the estimated Variable Annual Payment (which is not required to be paid in respect of the first 36 months following the Merger Date); and (vi) the estimated full synergies. We note that the Directors also consider that the increase to the Company's consolidated cashflow for 2006 arising from the operating activities of KCRC even after accounting for these factors to be very significant.

***Gearing Ratio***

As a result of the Rail Merger, the Company states in the Circular that its pro-forma gearing ratio as at 30 June 2007 (net debt/equity) will increase to 44.5% excluding capitalised fixed annual payments (or 57.7% including capitalised Fixed Annual Payments) from the present level of 30.8% as at 30 June 2007. We note that this pro-forma gearing level is similar to gearing levels experienced by the Company in certain previous years (e.g. 2002: 59.3% and 2003: 55.2%) and we consider it to be a reasonable gearing level for the Company given the stability of its cashflows. We also note that the Company expects that the increased cashflow from the Rail Merger will reduce the gearing level and enhance interest cover levels over time.

***Credit Profile***

We note that on 16 July 2007, Standard & Poor's affirmed its 'AA' long-term and 'A-1+' short-term corporate credit ratings for MTRC, with a stable outlook. The rating affirmations took into account the potential Rail Merger.

Following an upgrade to the outlook on the sovereign rating of Hong Kong, we note that, on 26 July 2007, Standard & Poor's affirmed its 'AA' long-term and 'A-1+' short-term corporate credit ratings for MTRC, and upgraded MTRC from a stable to a positive outlook.

We note that, on 16 July 2007, Moody's announced that it continued to review MTRC's ratings for a possible upgrade. The ratings review took into account the potential Rail Merger.

Following an upgrade to the sovereign rating of Hong Kong to 'Aa2' from 'Aa3', we note that, on 26 July 2007, Moody's upgraded the foreign currency issuer and senior unsecured debt ratings of MTRC to 'Aa2' from 'Aa3', with a stable outlook.

As a result, we do not anticipate any significant increase in the financing costs of MTRC.

***Dividends***

According to MTRC's annual reports, the Company declared a total annual dividend of HK$0.42 per Share for each of the last 6 fiscal years. Based on our discussions with MTRC's management, and as set out in the Letter from the Board contained in the Circular, we note that when the Board considers the amount of dividends to be declared, it takes into consideration, amongst other things, the financial performance of the

Company, the earnings for the year concerned, the Company's cashflow and its capital expenditure requirements. We note that the Company states in the Circular that the financial effects of the Rail Merger are such that, on a 2006 pro-forma basis, both earnings and cashflow would be increased as a result of the Rail Merger.

## 10. ADVICE

To summarise, in arriving at our advice, we have taken into consideration, among other things, the results of our work referred to above in section 8 of this letter and the following principal factors and reasons, which based on our discussions with the management of the Company we believe to be all the material factors, each of which is explained above in more detail in section 9 of this letter:

(i) the background to, and the potential strategic and financial benefits of the Rail Merger as identified by the Company, which are set out in greater detail in the Letter from the Board contained in the Circular;

(ii) our illustrative net present value analysis of the cashflows that can reasonably be expected to be generated by the Service Concession and the Purchased Rail Assets over the Concession Period, taking into account the Upfront Payment of HK$4.25 billion, expected one-off charges and the fixed and variable consideration payable over the Concession Period;

(iii) the likely impact of the FAM on the Company's fare levels as compared to what can reasonably be expected to be achieved under a full fare autonomy regime based on historical precedent;

(iv) the likely impact of reasonable periods of inflation or deflation, based on historical precedent, on the consideration payable by the Company under the Variable Annual Payment mechanism and the resultant impact on the value of the Service Concession and the Purchased Rail Assets over the Concession Period;

(v) the potential synergies that the Company expects to generate from the Rail Merger;

(vi) the professional valuation of the KCRC Investment Properties and KCRC Property Development Rights by Jones Lang LaSalle as at 31 July 2007 of HK$10,574 million as compared to MTRC's acquisition cost of HK$7.75 billion; and

(vii) the potential financial effects of the Rail Merger on the Company, as measured by key financial metrics such as earnings, cashflow, and gearing as well as the likely impact of the Rail Merger on the future dividend policy of the Company as set out in the Letter from the Board contained in the Circular.

Based on our discussions with the management of the Company, we are satisfied that the transaction has been negotiated on an arm's length basis. In addition, as outlined in the Letter from the Board contained in the Circular, the Board established and maintained a framework for its decision making process in relation to the Rail Merger, which sought to protect the interests of the Independent Shareholders. Such framework included the disclosure of each relevant Director's respective interest in the Rail Merger and the absence of certain members of the Board who had conflicts of interest (including representatives from the Government) from certain relevant parts of the meetings at which the Rail Merger was considered. However, as there are no comparable precedents for the Rail Merger, we are not able to form an opinion as to whether the Rail Merger is on normal commercial terms. Given the transformational nature of the Rail Merger, we are of the opinion that the Rail Merger is not in the ordinary and usual course of business of the Company.

It should be noted that while we have performed analysis on each, major component part of the Rail Merger, our advice is based on an overall assessment of the Rail Merger as a whole. Based upon and subject to the foregoing and such other matters as we consider relevant, and as at the date of this letter, we are of the opinion that the terms and conditions of the Rail Merger considered as a whole are fair and reasonable and in the interests of MTRC and its Shareholders as a whole. Accordingly, we advise the Independent Board Committee to recommend to the Independent Shareholders to vote in favour of the EGM Resolution and we advise the Independent Shareholders to vote in favour of the EGM Resolution.

Yours faithfully,
for and on behalf of
**MERRILL LYNCH (ASIA PACIFIC) LIMITED**
Kalpana Desai
*Managing Director*

*The information set out in this section and elsewhere in this Circular with respect to public transportation in Hong Kong has been obtained from publicly available documents or from sources specified herein which have not been prepared or independently verified in connection with the Rail Merger. In particular, statements regarding Government policy may be subject to change. No information set out herein will be updated.*

## PUBLIC TRANSPORTATION IN HONG KONG

### Overview

Hong Kong, with a land area of only 1,104 $km^2$, has a population of approximately 7 million. Every day, over 11 million passenger journeys are made on Hong Kong's public transport system which includes two high capacity railway systems, franchised and non-franchised buses, trams, public light buses, ferries and taxis.

The MTRC Railway, which commenced operations in 1979, is Hong Kong's metropolitan railway. It comprises the MTR Lines (which includes the Kwun Tong Line, Tsuen Wan Line, Island Line, Tung Chung Line, Tseung Kwan O Line and Disneyland Resort Line) and serves parts of Hong Kong Island, Kowloon, the New Territories and Lantau Island including the Hong Kong Airport via the Airport Express Line.

The KCRC Railway comprises East Rail, MOS Rail, Light Rail and West Rail. East Rail provides services from Tsim Sha Tsui through the New Territories to the Lo Wu and Lok Ma Chau boundary crossings to the Mainland. MOS Rail, which commenced operations in 2004, serves between Wu Kai Sha and Tai Wai in the eastern New Territories, having an interchange with East Rail at Tai Wai. Light Rail, which commenced operations in 1988, is a localised transport system and operates in the North-west New Territories in the new towns of Tuen Mun and Yuen Long. West Rail, which commenced operations in 2003, is the direct rail link between the North-west New Territories and urban Kowloon.

In addition, there are two tramway systems in Hong Kong, Hongkong Tramways and the Peak Tramways. These operate on the northern shore of Hong Kong Island and between Central and the Peak, respectively.

Public road passenger transport is provided by franchised and non-franchised buses, red and green public light buses and taxis. These accounted for approximately 60% of all public transport journeys in Hong Kong in 2006. Also in 2006, more than half of public transport journeys made by road were on franchised buses. Franchised buses are operated by Kowloon Motor Bus, New World First Bus, Citybus, New Lantao Bus and Long Win Bus. At the end of 2006, there were 18,031 taxis in Hong Kong, carrying an estimated daily average of approximately 1.0 million passengers. Their fares are charged according to approved fare scales.

Ferries are essential for travelling to and from certain of Hong Kong's outlying islands. In addition, they are a supplementary mode of transport to buses and the MTRC Railway for journeys involving the crossing of Victoria Harbour. Franchised services are provided by the ''Star'' Ferry Company, Limited (the ''**Star Ferry**''). The Star Ferry operated 13 vessels across the harbour and carried approximately 79,700 passengers daily on its four routes in 2006. New World First Ferry and other licensed ferries provide services to Mui Wo and Discovery Bay on Lantau Island and to Peng Chau, Cheung Chau and other outlying islands. Ferries carried an estimated daily average of approximately 154,200 passengers in 2006.

The following table shows the total number of boardings made by passengers within Hong Kong on different kinds of public transport operators in each of the three calendar years ended 31 December 2006:

| | Year ended 31 December | | |
|---|---|---|---|
| | **2004** | **2005** | **2006** |
| | *Average daily public transport passenger (thousands)* | | |
| **Railways and tramways** | | | |
| Mass Transit Railway | 2,299.4 | 2,373.9 | 2,400.9 |
| East Rail | 803.5 | 895.9 | 922.0 |
| Light Rail | 359.8 | 373.0 | 373.7 |
| West Rail | 130.6 | 177.4 | 197.9 |
| Hong Kong Tramways and Peak Tramways | 243.2 | 241.5 | 242.1 |
| Sub-total | 3,836.5 | 4,061.7 | 4,136.6 |
| **Franchised buses** | 4,081.0 | 3,918.2 | 3,943.2 |
| **Residents' Services** | 177.4 | 177.6 | 182.1 |
| **KCRC Light Rail Transit feeder buses** | 54.8 | 74.5 | 82.4 |
| **Public Light Buses**(1) | 1,709.3 | 1,759.4 | 1,798.5 |
| **Taxis**(2) | 1,032.3 | 1,026.0 | 1,067.1 |
| **Ferries** | 155.0 | 153.6 | 154.2 |
| Total | 11,046.4 | 11,170.8 | 11,364.1 |

*Source:* Monthly Traffic and Transport Digest published by the Government.

*Notes:*

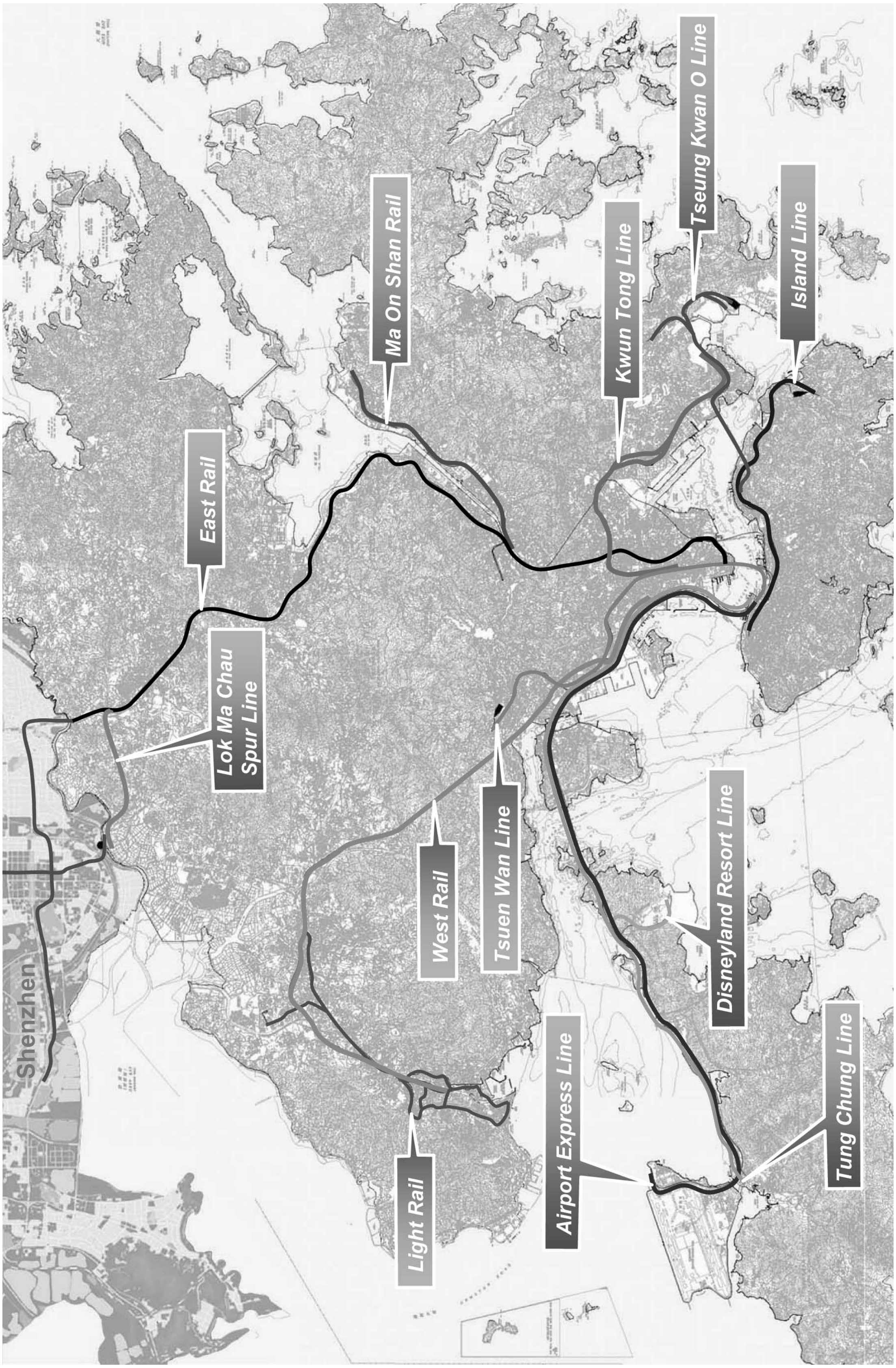
(1) Includes green public light buses and red public light buses

(2) Estimated figures by the Transport Department.

### Railways

Railways play a vital role in serving the transport needs of Hong Kong. The existing railway network in Hong Kong has a total length of approximately 211 km and comprises the MTRC Railway and the KCRC Railway.

**Existing and Committed MTRC and KCRC railways in Hong Kong**



### *The Mass Transit Railway*

The MTRC Railway comprises the MTR Lines and the Airport Express Line. Further details of the MTRC Railway are contained in the paragraph headed "The MTRC Railway" in the section of this Circular headed "Information on the Business of the Company".

### *The Kowloon-Canton Railway*

The KCRC Railway comprises East Rail, MOS Rail, Light Rail and West Rail. Further details of the KCRC Railway are contained in the paragraph headed "The KCRC Railway" in the section of this Circular headed "Information on the Business of KCRC".

### *Cross-boundary traffic*

Total cross-boundary traffic by rail, road and ferry increased by 5% in 2006 to an average of 476,800 passengers a day. Lo Wu, previously the only rail boundary crossing into the Mainland, handled an average of 241,000 passengers daily or over 50% of the average daily passenger flow in 2006, an increase of 2.3% from 235,500 passengers daily in 2005. The opening of the LMCSL on 15 August 2007 provided a second rail boundary crossing. Unlike the rail terminus at Lo Wu which serves rail passengers only, the terminus at Lok Ma Chau handles passengers using the LMCSL, buses serving the North-west New Territories as well as taxis. KCRC also operates through trains to Guangzhou, Beijing and Shanghai which carried 8,970 passengers daily in 2006, an increase of 5.3% from 8,520 passengers daily in 2005. Rail therefore makes up 52% of the total cross boundary market (excluding air traffic).

There are four road crossings between Hong Kong and the Mainland: Lok Ma Chau, Man Kam To, Sha Tau Kok and the Hong Kong-Shenzhen Western Corridor. The Lok Ma Chau, Man Kam To and Sha Tau Kok crossings handled an average of 134,300, 8,400 and 7,300 travelers daily in 2006 respectively, an increase of 9.9%, 1.2% and 21.7% over the average of 122,200, 8,300 and 6,000 travelers daily in 2005 respectively. The Hong Kong-Shenzhen Western Corridor was opened to the public on 1 July 2007. These road crossings are used by private cars, buses, coaches, goods vehicles and container trucks to transport passengers and cargo between Hong Kong and the Mainland. There are three different types of cross-boundary public transport services using these road crossings, namely:

— The Lok Ma Chau - Huanggang Cross Boundary Shuttle Bus (commonly known as the "Yellow Bus") using the Lok Ma Chau road crossing.

— The Cross Boundary Coach Services with six fixed routes operating from Huanggang to six locations in Hong Kong using the Lok Ma Chau road crossing, as well as a number of point-to-point non-stop services between Hong Kong and the Mainland using all four road crossings. These coaches operate under the Passenger Service License regime which is a quota system, specifying the origin, destination, number of trips allowed within specified hours in a day and the control point used.

— Franchised buses and mini-buses to the public transport interchange next to the Hong Kong-Shenzhen Western Corridor control point.

## Buses and Public Light Buses

There are five franchised bus operators in Hong Kong. Kowloon Motor Bus is the largest franchised bus operator and principally operates in Kowloon and the New Territories. Local bus services on Hong Kong Island are currently provided by New World First Bus and Citybus. Cross-harbour services are provided by all three operators. New Lantao Bus provides bus services on Lantau Island, while Long Win Bus operates routes between the New Territories and Tung Chung and the Airport. Non-franchised bus services provide services for residents and employees, and serve groups of tourists and students on a hire basis. They perform a supplementary role in the public transport system by providing services primarily during peak hours.

Public light buses ("**PLBs**") are licensed to carry a maximum of 16 seated passengers. There are two types of PLBs: "green" and "red" PLBs. Green PLBs provide scheduled services, and their fares, vehicle allocation and timetables are stipulated by the Transport Department. Red PLBs operate without specified schedules. They are not required to operate on fixed routes or timetables and are free to set fares. They are however still subject to a number of road traffic restrictions.

The following table shows certain operating data for franchised and buses and PLBs for the three years ended 31 December 2006:

| | Year ended 31 December | | |
|---|---|---|---|
| | 2004 | 2005 | 2006 |
| | Average daily public transport passenger (thousands) | | |
| **Franchised Buses** | | | |
| Kowloon Motor Bus | 2,906.7 | 2,767.0 | 2,761.3 |
| Citybus | 576.0 | 561.9 | 569.2 |
| New World First Bus | 504.5 | 486.2 | 501.6 |
| Long Win Bus | 60.9 | 66.6 | 72.6 |
| New Lantao Bus | 32.9 | 36.6 | 38.5 |
| **Sub-total** | 4,081.0 | 3,918.2 | 3,943.2 |
| **PLBs** | | | |
| Green PLBs | 1,239.8 | 1,306.2 | 1,364.0 |
| Red PLBs | 469.5 | 453.2 | 434.5 |
| **Sub-total** | 1,709.3 | 1,759.3 | 1,798.5 |

*Source:* Monthly Traffic and Transport Digest published by the Government.

A fare adjustment mechanism was introduced to franchised buses in January 2006 ("**Bus FAM**"). In assessing franchised bus fare adjustment applications, the Bus FAM stipulates that a basket of factors should be taken into account, including the supportable fare adjustment rate ("**SFAR**"):

SFAR = 0.5 x $\triangle$CCPI + 0.5 x $\triangle$Wage Index - 0.5 x Productivity Gain,

- Where $\triangle$CCPI = % change in Government Composite Consumer Prices Index
- $\triangle$Wage Index = % change in C&SD Nominal Wage Index for the transport sector
- Productivity gain = bus industry-wide productivity gain. For the first term of the Bus FAM (2006-2009), "0.5 x Productivity Gain" has been set to equal 0.3%

The Bus FAM is reviewed every 3 years for which the Chief Executive in Council has the final right of approval.

**Population**

The population of Hong Kong was estimated at 6,857,100 as at mid-2006, representing an annual average increase of 0.4% over the previous 5 years. The land population density per km$^2$ was 6,350 in 2006.

In 2007, the Government published population projections and set out its population projections from 2006 to 2036, extracts of which are set out below:

| | Mid-2006 | Mid-2011 | Mid-2016 | Mid-2021 | Mid-2026 | Mid-2031 | Mid-2036 |
|---|---|---|---|---|---|---|---|
| Population | 6,857,100 | 7,153,500 | 7,450,000 | 7,784,000 | 8,094,000 | 8,360,700 | 8,570,200 |
| Average annual growth rate over a 5-year period | 0.4% | 0.8% | 0.8% | 0.9% | 0.8% | 0.7% | 0.5% |

*Source:* Hong Kong Census and Statistics Department.

## GOVERNMENT TRANSPORT STRATEGY

The Government has, in the past, published a number of papers with respect to its transport policy and strategy. These include a paper published in October 1999 entitled "Hong Kong Moving Ahead — A Transport Strategy for the Future'', a paper published in March 1998 entitled RDS-2, a paper resulting from RDS-2 headed RDS 2000 which was published in May 2000 and a paper in November 2006 which reaffirmed its position with respect to certain elements of RDS 2000. Each of these papers are discussed below but it should be noted that as historic papers, certain information and statements contained therein may not accurately reflect the Governments existing policy or intentions.

The Government's current transport policy ''Hong Kong Moving Ahead — A Transport Strategy for the Future'', was published in October 1999. It focuses on:

- **Better integration of transport and land use planning.** With an objective to provide a transport infrastructure in a timely and cost-effective manner, with due regard for the environment, the Government has stated the importance of providing new systems, and improving existing infrastructure, which would entail giving priority to railway development;
- **Better use of railways as the back-bone of passenger transport system.** The Government has stated that locating future strategic developments along rail alignments will reduce reliance on road-based transport, enhance the efficiency of the rail network, and ensure affordable fare levels. Railways will be supplemented by ''feeder'' services using other public transport modes;
- **Better public transport services and facilities.** The Government has recognised the need to upgrade the public transport system by rationalising and improving public transport services to better match demand, minimising wasteful competition and duplication of effort and curtailing, in some cases, low demand services. In addition, convenient and comfortable interchange facilities at transport hubs, especially railway stations, will be included in plans for new and major land-use or transport developments. The Government has also stated that franchised buses will play a more prominent role in feeding passengers to the railways. Unnecessary duplication generated by point-to-point services will be reduced through the use of conveniently located interchange facilities. The Government has also stated that healthy competition among service providers will be maintained to ensure commuters' choice;
- **Better use of advanced technologies in transport management.** The Government's objective is that the use of new technologies will be encouraged to increase the efficiency of traffic management, improve the overall capacity of the road system, and enhance road safety; and
- **Better environmental protection.** The Government's objective is that transport infrastructure and services will be provided in an environmentally acceptable manner to ensure the sustainable development of Hong Kong. On the transport front, this will include giving priority to efficient, environmentally friendly transport modes such as railways.

To summarise, one of the focal points of the Government's current transport strategy is to accord priority to railways with the intention that railways will form the backbone of the future passenger transport network.

### Second Railway Development Study ("RDS-2")

In order to cater for Hong Kong's continued population growth and the increasing cross boundary social and economic activities, the Government commissioned the RDS-2 in March 1998 to examine how best to further expand the rail network to the year 2016. The executive summary of the RDS-2 report was published in May 2000 and examined the needs of the future railway network to fulfil the following objectives:

- to relieve bottlenecks in the existing railway systems;
- to provide rail service to strategic growth areas for housing and economic development;
- to meet cross-boundary passenger and freight demands; and
- to increase the share of rail in the overall transport system to reduce reliance on road-based transport.

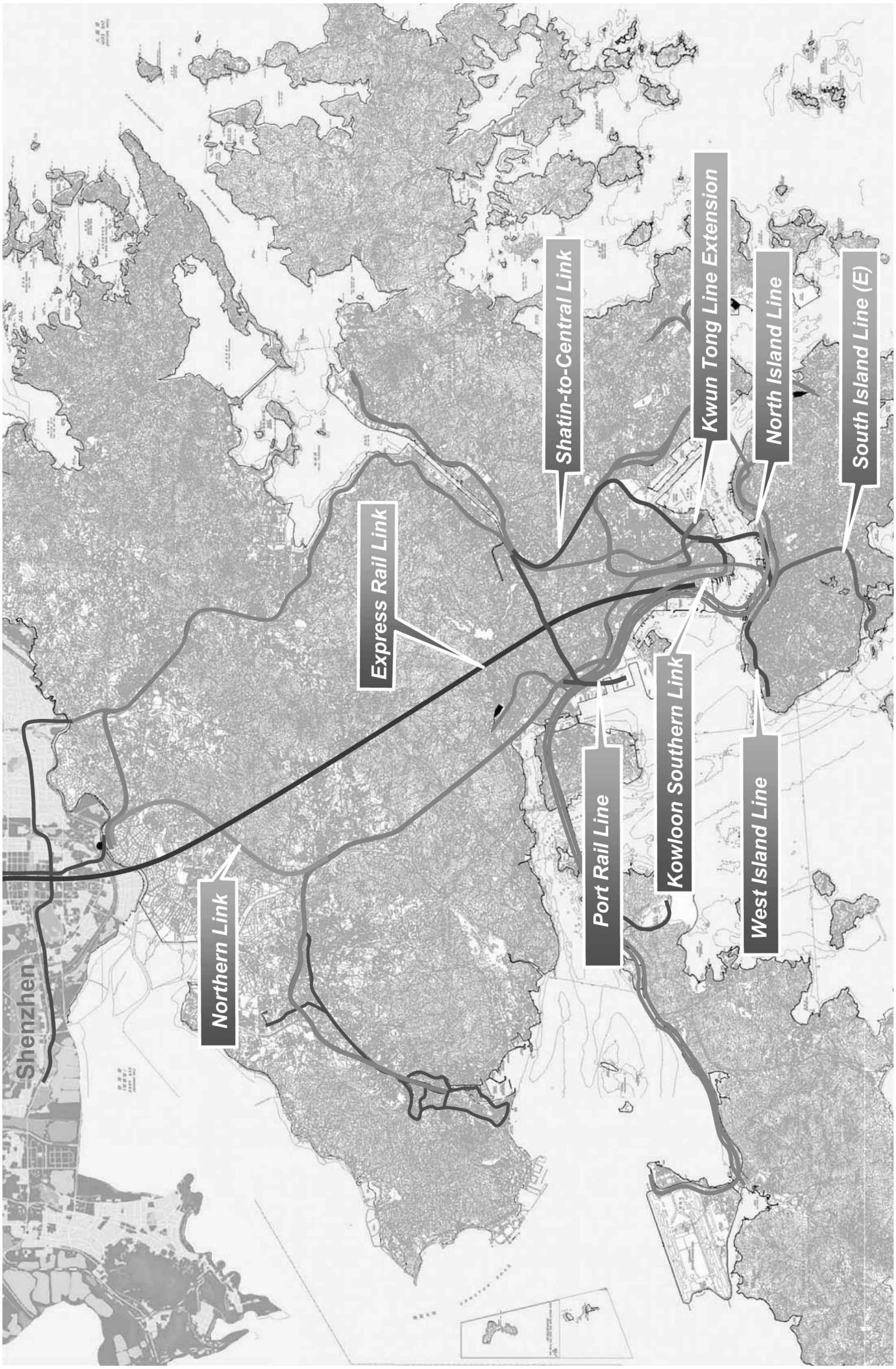
### Railway Development Strategy 2000

Based on the key findings of RDS-2, the Government formulated the Railway Development Strategy 2000, which was published in May 2000. On completion of the railway network expansion plan as set out in the Railway Development Strategy 2000, it is estimated that the share of railways in Hong Kong's public transport is expected to increase from 31% in 1998 to 43% by 2016.

The recommended network in the Railway Development Strategy 2000 will feature six new rail corridors and a potential Port Rail Line ("**PRL**"). The six proposed rail corridors are as follows:

- an east-west corridor from Chai Wan to Tung Chung formed by the Island Line, the proposed North Hong Kong Island Line ("**NIL**") and the Tung Chung Line;
- a second east-west corridor from Tseung Kwan O to Kennedy Town formed by the Tseung Kwan O Extension, the Island Line, and the proposed West Hong Kong Island Line ("**WIL**");
- a north-south corridor which, depending on the operator, could run direct from either Tai Wai or Ma On Shan to Hong Kong Island via southeast Kowloon. This will be a new strategic rail corridor of which the Fourth Rail Harbour Crossing is a component;
- a Kowloon Southern Link that would provide convenient connection between East Rail and West Rail via the Kowloon peninsula;
- a Northern Link ("**NOL**") that would connect the East Rail and West Rail at the northern part of the New Territories; and
- an Express Rail Link ("**ERL**") (formerly known as the Regional Express Line that would provide rapid rail transport between the boundary with the mainland of China and the metropolitan areas).

**Future Railway Network**



***New railway projects***

The Government has grouped the new railway schemes identified above into the following projects for implementation:

- **Island Line Extensions.** The Island Line Extensions comprise a new North Hong Kong Island Line and a West Hong Kong Island Line. The Railway Development Strategy 2000 stated that as both NIL and WIL are natural extensions of the Island Line, they should be implemented as a package by the Company;
- **Shatin to Central Link.** The Shatin to Central Link will be a new strategic rail corridor in the rail network formed by East Kowloon Line, the Fourth Rail Harbour Crossing and the Tai Wai to Diamond Hill Link;
- **Kowloon Southern Link.** The KSL is an extension of West Rail from its Nam Cheong station to connect with the Tsim Sha Tsui extension;
- **Northern Link.** The NOL will connect West Rail at Kam Sheung Road to East Rail at Kwu Tung and to the boundary crossing point at Lok Ma Chau. It will provide domestic passenger service for the strategic growth areas in north New Territories and cross-boundary passenger service for the western part of Hong Kong;
- **Express Rail Link (formerly known as the Regional Express Line).** The ERL will be an express rail service which is anticipated to link the urban area with the boundary with the mainland of China. In addition to providing fast domestic service with limited stops, through trains may also run on the ERL. The preliminary alignment of the ERL will link West Kowloon to the border; and
- **Port Rail Line.** The PRL is a new freight rail connection from Lo Wu to a new port rail terminal at Kwai Chung.

***Development of railway projects identified in RDS 2000***

The status on the progress of the six railways stipulated in RDS 2000 is as follows:

- **Island Line Extensions.** In view of the reduced population and employment on Hong Kong Island, the Government decided in January 2003 to defer the completion of the NIL to beyond 2016. The Company was asked by the Government in June 2005 to proceed with preliminary planning and design of the WIL. A revised project proposal was submitted to the Government in August 2006 and is currently being assessed.
- **Shatin to Central Link.** After a competitive bidding exercise, the Government decided to award the SCL to KCRC in June 2002. In September 2004 KCRC submitted a draft final proposal for the SCL to the Government. According to the Transport and Housing Bureau, the SCL remains a committed project for implementation. It stated in a paper to the Legislative Council Panel on Transport dated 16 July 2007 (LC Paper No. CB(1)2058/06-07(01)): "*The Administration has promised to make a decision on the way forward, including the scheme and timetable for the SCL within six months after the completion of the legislative process for the rail merger.*" The section entitled 'Information on the Business of KCRC' contains further information on the background to and progress of the SCL project.
- **Kowloon Southern Link.** The KSL was gazetted under the Railways Ordinance on 26 March 2004. Construction of KSL commenced in 2005 and is due to be commissioned in 2009.
- **Northern Link.** Further work has been carried out on the technical, environmental and financial aspects of the NOL to allow the Government to better assess the transport and economic benefits of the project.
- **Express Rail Link.** KCRC submitted a project proposal for a dedicated Regional Express Link to the Government in June 2007.
- **Port Rail Line.** KCRC is now studying the feasibility of this rail link.

***Benefits of the expanded railway network***

The Railway Development Strategy 2000 stated that railways will be vital in supporting the economic, social and population growth of Hong Kong in the next 15 years. It also stated that investing in the new railway network will yield the following benefits to the community:

- **Improving accessibility.** Implementing the expanded network will place about 70% of the population and about 80% of job opportunities within one km of a railway station;
- **Realisation of integrated transport planning.** The comprehensive network coverage will facilitate co-ordination with other public transport services at key interchange stations. This will enable the realisation of integrated transport planning in which railways will form the backbone of Hong Kong's transport system;
- **High level of transport service.** The comprehensive network will offer fast and reliable travel throughout Hong Kong. The journey times from Lo Wu to Admiralty and from Tseung Kwan O to Central are estimated to be 50 and 21 minutes, respectively;
- **Meeting cross-boundary demand.** The network will be able to meet the growing cross-boundary demand, which is forecast to increase by over three times by 2016;
- **Economic return.** The investments in the network will yield an economic internal rate of return of more than 15%; and
- **Environmental benefits.** The new railway network will, on completion, increase the rail share in the public transport system from 31% in 1998 to 43% by 2016, or in terms of the distance travelled by passengers, from 34% to almost 60%. This is expected to reduce the reliance on road-based transport and translate into environmental benefits.

***Future Strategy***

Despite the targeted commissioning dates set out in RDS 2000, the Government has stated that flexibility should be maintained on the timing of the six projects. This statement is in response to the changes in economic/population forecasts and conditions and public expectations experienced since the publication of RDS 2000. The underlying principle behind the Government's policy is to re-examine rail capacity assumptions based on public acceptance on level of comfort with a view towards maximizing the public utility, and financial and economic case for the various rail projects. In November 2006 the Government published a paper headed "Railway Development". In the paper the Government reaffirmed its railway strategy as previously set out in RDS 2000 and in addition stated that it would continue to monitor and review any changes in land use, population and transport parameters in planning the delivery of railway projects in a timely manner.

## THE PROPERTY MARKET IN HONG KONG

### General

All land within Hong Kong is Government land and the Government is responsible for its management, use and development and for its lease or grant.

Property in Hong Kong is almost entirely held under long term leases granted by the Government in return for upfront lump sum capital payments borne by lessees. A person who holds a piece of land under a long-term lease from the Government is usually referred to as the owner of the relevant property. Such leases are called Government leases and, since 1 July 1997, are granted normally for a term of 50 years for most types of property from the date of the grant at a premium and, subject to an annual rent equivalent to 3% of the rateable value of the property at the relevant date, adjusted in step with any changes in the rateable value thereafter.

There are usually various restrictive covenants in Government leases, including land use and development restrictions. Additional land use restrictions are also imposed by local town planning legislation. If a lessee wishes to modify the use restrictions or to remove development restrictions in a Government lease, the lessee must apply to the Government for modification of the original terms of the Government lease, subject to payment of a premium as consideration for the modification.

The Hong Kong property market can generally be classified into four sectors, namely, residential, office, commercial/retail and industrial. Traditionally, most residential developments are built for sale. Properties in the Hong Kong leasing market are usually leased to tenants under agreements with terms of two to three years, or with rights to renew for terms of a similar duration with reviewed rents. These terms enable landlords in Hong Kong to benefit from improving market conditions by way of rental revisions more frequently than in some other jurisdictions. However, the frequent expiry of leases also exposes Hong Kong landlords to any decline in rental values and increasing vacancy rates from time to time.

The following table shows the number of residential sales transactions in each year for the period from 1997 to 2006:

| **Year** | **Number of residential sales transactions[(1)]** |
|---|---|
| 1997 | 172,711 |
| 1998 | 85,616 |
| 1999 | 77,087 |
| 2000 | 65,340 |
| 2001 | 69,667 |
| 2002 | 72,974 |
| 2003 | 71,576 |
| 2004 | 100,630 |
| 2005 | 103,362 |
| 2006 | 82,472 |

*Source:* Land Registry.

*Note:*

(1) The figures relate to residential property which account for approximately 76% to 88% of the annual transactions of building units during the reporting years.

**Residential property**

The residential property market in Hong Kong comprises three sectors: private housing, public housing rental flats and Government-subsidised sale flats. The private residential market comprised about 1,069,000 units as at the end of 2006, of which approximately 93% were units of less than 100 $m^2$ saleable area. Approximately 62% of all private housing is located on Hong Kong Island and in Kowloon, and the remaining 38% in the New Territories. The proportion of units in the New Territories has increased over the last 10 years as a result of the Government's new town development strategy, which aims to eliminate overcrowding in the existing urban areas of the Hong Kong Island and Kowloon.

The following table shows the residential price index and average price in each of the years from 1997 to 2006, together with price per square foot data:

**Residential(1) Price Index and Average Price**

**(Index: 1 January 1999 = 100)**

| Year | Index | Average price |
|---|---|---|
| 1997 | 163.1 | 6,742 |
| 1998 | 117.1 | 4,576 |
| 1999 | 100.0 | 3,827 |
| 2000 | 89.6 | 3,468 |
| 2001 | 78.7 | 3,037 |
| 2002 | 69.9 | 2,743 |
| 2003 | 61.6 | 2,485 |
| 2004 | 78.0 | 3,316 |
| 2005 | 92.0 | 3,863 |
| 2006 | 92.6 | 3,860 |

*Source:* Hong Kong Property Review 2007 (Rating and Valuation Department, HKSAR)

*Notes:*

(1) Private domestic units are defined as independent dwellings with separate cooking facilities and bathroom. Properties are categorised according to the use for which the occupation permit was originally issued, unless known to have been subsequently structurally altered.

(2) The indices measure value changes by reference to rateable value. The index for 2006 is provisional.

(3) The average price is the price per square foot on saleable area for Type C units, that is, units of 70 to 99.9 square metre saleable area as defined by the Rating and Valuation Department, HKSAR, in the New Territories. The price for 2006 is provisional.

Approximately 16,580 units were completed in 2006, 4% less than in 2005. The New Territories accounted for about 54% of the total. Vacancy at the end of 2006 was approximately 62,670 units, representing 5.9% of stock, comparing to 6% in 2005. The following table shows supply and vacancy trends for the private domestic sector for the period from 2002 to 2006:

**Private Domestic(1) — Overall Supply and Vacancy Trends**

| | In buildings completed during the year | | | In all other buildings | | | Overall vacancy | |
|---|---|---|---|---|---|---|---|---|
| | Total no. of units | No. vacant | % vacant | Total no. of units | No. vacant | % vacant | No. vacant | % of total stock |
| 2002 | 31,052 | 26,592 | 85.6 | 950,924 | 38,675 | 4.1 | 65,267 | 6.6 |
| 2003 | 26,397 | 22,885 | 86.7 | 981,578 | 45,896 | 4.7 | 68,781 | 6.8 |
| 2004 | 26,036 | 21,871 | 84.0 | 1,008,935 | 42,377 | 4.2 | 64,248 | 6.2 |
| 2005 | 17,321 | 16,646 | 96.1 | 1,035,925 | 46,893 | 4.5 | 63,539 | 6.0 |
| 2006 | 16,579 | 14,542 | 87.7 | 1,052,319 | 48,128 | 4.6 | 62,670 | 5.9 |

*Source:* Hong Kong Property Review 2007 (Rating and Valuation Department, HKSAR).

*Notes:*

(1) See Note (1) to the table on Residential Price Index and Average Price above.

(2) All figures represent year-end position.

### Office property

Office space in Hong Kong is diversely located in a number of core business districts including Sheung Wan, Central, Wanchai, Causeway Bay and Tsim Sha Tsui, as well as a number of other areas such as North Point, Quarry Bay, Kowloon Bay, Mong Kok, Kwun Tong and Tsuen Wan. Office space in the core business districts accounted for 65% of the total stock at the end of 2006. Rental rates and capital values are affected by supply of new space, market demand for take-up of available space and the resultant vacancy rates.

The following table shows the annual rental and price indices for the private office sector for the period from 1997 to 2006:

**Private Offices(1) — Rental and Price Indices(2)**

**(1999 = 100)**

| Year | Rentals | Prices |
|---|---|---|
| 1997 | 157 | 213 |
| 1998 | 136 | 135 |
| 1999 | 100 | 100 |
| 2000 | 99 | 90 |
| 2001 | 101 | 79 |
| 2002 | 85 | 68 |
| 2003 | 75 | 63 |
| 2004 | 78 | 99 |
| 2005 | 96 | 133 |
| 2006 | 117 | 139 |

*Source:* Hong Kong Property Review 2007 (Rating and Valuation Department, HKSAR).

*Notes:*

(1) Properties comprise premises situated in buildings designed for commercial/business purposes. Non-domestic floors in composite buildings are, however, excluded. Properties are categorised according to the use for which the occupation permit was originally issued, unless known to have been subsequently structurally altered.

(2) The indices measure value changes by reference to rateable value and not to floor area. The indices for 2006 are provisional.

The following table shows supply and vacancy trends for the private office sector for the period from 2002 to 2006:

**Private Offices(1) — Overall Supply and Vacancy Trends**

| | In buildings completed during the year | | | In all other buildings | | | Overall Vacancy | |
|---|---|---|---|---|---|---|---|---|
| | Total floor space(2) ($m^2$) | Amount vacant ($m^2$) | % vacant | Total floor space(2) ($m^2$) | Amount vacant ($m^2$) | % vacant | Amount vacant ($m^2$) | % of total stock |
| 2002 | 165,600 | 105,400 | 63.6 | 9,120,900 | 1,069,100 | 11.7 | 1,174,500 | 12.6 |
| 2003 | 298,800 | 220,700 | 73.9 | 9,240,400 | 1,113,100 | 12.0 | 1,333,800 | 14.0 |
| 2004 | 279,500 | 234,400 | 83.9 | 9,515,400 | 1,005,500 | 10.6 | 1,239,900 | 12.7 |
| 2005 | 34,100 | 4,400 | 12.9 | 9,735,600 | 849,400 | 8.7 | 853,800 | 8.7 |
| 2006 | 108,200 | 94,100 | 87.0 | 9,704,600 | 658,700 | 6.8 | 752,800 | 7.7 |

*Source:* Hong Kong Property Review 2007 (Rating and Valuation Department, HKSAR).

*Notes:*

(1) See Note (1) to the table on Private Offices — Rental and Price Indices above.

(2) All areas are internal floor areas.

(3) All figures represent year-end position.

### Commercial/retail property

The private commercial/retail property market in Hong Kong comprises approximately 10,396,000 $m^2$ of shopping plazas, restaurants, retail outlets and other commercial/retail space as at the end of 2006. The market is geographically diverse. Both luxury retail and mass retail premises are found throughout the major population centers of Hong Kong Island, Kowloon and the New Territories. There are particularly high concentrations of commercial space in the traditional shopping areas of Causeway Bay, Central, Tsim Sha Tsui and Mong Kok.

The following table shows the rental and price indices for the private retail sector for the period from 1997 to 2006:

**Private Retail Premises(1) — Rental and Price Indices(2)**

**(1999 = 100)**

| Year | Rentals | Prices |
|---|---|---|
| 1997 | 124 | 177 |
| 1998 | 111 | 128 |
| 1999 | 100 | 100 |
| 2000 | 101 | 94 |
| 2001 | 99 | 87 |
| 2002 | 93 | 85 |
| 2003 | 86 | 86 |
| 2004 | 93 | 119 |
| 2005 | 101 | 149 |
| 2006 | 105 | 153 |

*Source:* Hong Kong Property Review 2007 (Rating and Valuation Department, HKSAR).

*Notes:*

(1) Properties are categorised according to the use for which the occupation permit was originally issued, unless known to have been subsequently structurally altered.

(2) The indices measure value changes by reference to rateable value. The indices for 2006 are provisional.

Completions of commercial/retail space in 2006 were 182,800 $m^2$, 65% higher than last year. Take-up was 176,000 $m^2$ in 2006. Overall vacancy at the year end increased to 1,022,600 $m^2$, being 9.8% of stock.

The following table shows supply and vacancy trends for the private commercial sector for the period 2002 to 2006:

**Private Retail/Commercial Premises(1) — Overall Supply and Vacancy Trends**

| | In buildings completed during the year | | | In all other buildings | | | Overall vacancy | |
|---|---|---|---|---|---|---|---|---|
| | Total floor space(2) ($m^2$) | Amount vacant ($m^2$) | % vacant | Total floor space(2) ($m^2$) | Amount vacant ($m^2$) | % vacant | Amount vacant ($m^2$) | % of total stock |
| 2002 | 138,000 | 122,300 | 88.6 | 9,092,700 | 868,500 | 9.6 | 990,800 | 10.7 |
| 2003 | 117,900 | 90,500 | 76.8 | 9,187,700 | 911,700 | 9.9 | 1,002,200 | 10.8 |
| 2004 | 91,300 | 68,700 | 75.2 | 9,316,500 | 950,700 | 10.2 | 1,019,400 | 10.8 |
| 2005 | 110,700 | 23,000 | 20.8 | 9,411,700 | 957,100 | 10.2 | 980,100 | 10.3 |
| 2006 | 182,800 | 168,500 | 92.2 | 10,212,700 | 854,100 | 8.4 | 1,022,600 | 9.8 |

*Source:* Hong Kong Property Review 2007 (Rating and Valuation Department, HKSAR).

*Notes:*

(1) Properties are categorised according to the use for which the occupation permit was originally issued, unless known to have been subsequently structurally altered.

(2) All figures represent year-end position.

## INTRODUCTION

The Mass Transit Railway Corporation was established in 1975 under the Mass Transit Railway Corporation Ordinance (Cap. 270 of the Laws of Hong Kong) to construct and operate a mass transit railway system in Hong Kong as a statutory corporation, and was wholly-owned by the FSI on trust on behalf of the Government. In 1979, the first section of the Mass Transit Railway was opened for passenger service followed by other lines in 1982 and 1986. In 1998 the Airport Express, a purpose-built railway serving Hong Kong's Chek Lap Kok Airport, was opened for passenger service.

The Company was privatised on 5 October 2000 by way of an offer for sale of 1,000,000,000 MTRC Shares by the FSI on behalf of the Government. On 1 November 2000, the FSI completed the sale of an additional 150,000,000 MTRC Shares pursuant to an over-allotment option granted to the underwriters of the original share offer. As at the Latest Practicable Date, the FSI, on behalf of the Government, holds 4,285,040,314 Shares representing approximately 76.67% of the total issued share capital of the Company.

## THE MTRC RAILWAY

The MTRC Railway comprises seven inter-connecting lines: the Tsuen Wan Line, the Kwun Tong Line, the Island Line, the Tung Chung Line, the Tseung Kwan O Line, the Disneyland Resort Line and the Airport Express.

Construction of the Kwun Tong Line, the Tsuen Wan Line and the Island Line took place between 1975 and 1986 with the railway part of the Eastern Harbour Tunnel being constructed by a private consortium between 1986 and 1989. The Mass Transit Railway Corporation entered into an agreement with the consortium to operate the railway part of the Eastern Harbour Tunnel and in return is making a series of fixed semi-annual payments totalling HK$2.6 billion to the Eastern Harbour Crossing Company Limited over a period of 18.5 years from the date of operation. The total cost of construction of these Lines was approximately HK$26 billion. Construction of the Tung Chung Line and the Airport Express took place between 1994 and 1998. The total construction cost of the Tung Chung Line and the Airport Express was HK$35.1 billion. The total construction cost of the Tseung Kwan O Line was approximately HK$16 billion and was completed in 2002. Construction of the Disneyland Resort Line took place between 2002 and 2005 with a total construction cost of approximately HK$1.7 billion, before Government support of HK$0.9 billion.

### Patronage

The number of passengers carried for each of the years 2002 to 2006 is set out in the table below. The total patronage for the MTR Lines for the year ended 31 December 2006 was 867 million, representing an increase of approximately 1% as compared with 2005. For the first six months of 2007, total patronage on the MTR Lines reached another record of 429.3 million, a 2.6% increase over the same period in 2006.

For the year ended 31 December 2006, patronage on the Airport Express increased by approximately 12.8% to 9.6 million, as compared to 8.5 million passengers in 2005. The increase was primarily due to the opening of the AsiaWorld-Expo Station in December 2005. For the first six months of 2007, passenger volume on Airport Express rose 7.2% from 4.5 million to 4.8 million over the same period in 2006, as the number of air travellers using Hong Kong International Airport continued to rise, and the number of exhibitions and other events at the AsiaWorld-Expo increased.

| | Year ended 31 December | | | | | Six months ended 30 June | |
|---|---|---|---|---|---|---|---|
| | **2002** | **2003** | **2004** | **2005** | **2006** | **2006** | **2007** |
| **Total number of passengers** | | | | | | | |
| MTR Lines (in millions) | 777.2 | 770.4 | 833.6 | 858.0 | 866.8 | 418.4 | 429.3 |
| Airport Express (in thousands) | 8,457 | 6,849 | 8,015 | 8,493 | 9,576 | 4,512 | 4,836 |
| **Average number of passengers** (in thousands) | | | | | | | |
| MTR Lines - weekday average | 2,261 | 2,240 | 2,403 | 2,497 | 2,523 | 2,470 | 2,544 |
| Airport Express - daily average | 23 | 19 | 22 | 23 | 26 | 25 | 27 |

### Promotions

Promotion campaigns are run from time to time to encourage more patronage and to raise awareness of the Company's services.

Since its establishment in July 2000, the MTR Club has turned into a very successful program with over 660,000 members as at June 2007. Various promotions and the "Instant Points Scheme" programme were offered to MTR Club members to enhance their loyalty to the Company.

Promoting patronage through improved connectivity with other modes of transport remains important to maintaining the Company's market share. The Company is currently offering intermodal fare discounts to adult Octopus passengers using buses such as green minibus, New Lantao Bus and cross-boundary bus as a feeder connection to or from the designated MTR station(s) within a specific time limit. The number of intermodal fare discount schemes accumulated to 32 by the end of June 2007.

The Company is also offering a HK$1 to HK$2 discount on fares to adult Octopus passengers who swipe their Octopus on the fare savers, which are located outside of stations but still within walking distance of stations, and subsequently use the MTR Railway at the designated entry station. A total of 21 fare savers were in service by the end of June 2007.

### Future Extensions/Projects

#### *Island Line Extensions*

On 21 January 2003, the Government invited the Company to proceed with the planning for a rail service for the Western and Southern districts of Hong Kong Island. Two lines were envisaged, the West Island Line ("**WIL**") and the South Island Line ("**SIL**").

The Company commenced a feasibility study of the WIL and the SIL projects in mid-2003 and submitted a project proposal for a combined railway serving the districts to the Government at the end of March 2004. In February 2005 the Company submitted revised proposals for separate railway extensions to Southern and Western Districts of Hong Kong Island.

#### *West Island Line*

In June 2005 the Government formally invited the Company to proceed with the preliminary design of the proposed extension of the Island Line to serve Western District. The proposed extension consists of three underground stations at Sai Ying Pun, University and Kennedy Town. The preliminary design study is now completed and a revised proposal was submitted to the Government on 31 August 2006. The Company is now in negotiations with the Government over related reprovisioning works and the funding support needed for the project. The estimated railway cost is approximately HK$8.0 billion, with related public infrastructure estimated at approximately HK$1.0 billion. Assuming agreement can be reached, it is expected that detailed design would commence in 2007, which would enable the project to be completed in 2014.

#### *South Island Line*

The Company is involved in ongoing discussions with the Government on the implementation of the South Island Line (East), a proposed medium capacity railway serving Ap Lei Chau, Wong Chuk Hang, Ocean Park, and terminating at Admiralty and the project continues to receive strong community support.

In June 2007 a revised project proposal was submitted to the Government for the South Island Line (East). The estimated railway cost is approximately HK$7.2 billion.

#### *North Island Link*

Discussions are continuing with the Government on the revised proposals for the Wan Chai reclamation and the effect on the alignment of the proposed North Island Link including the location of new stations at Tamar and Exhibition to form a link between the Tung Chung Line at Hong Kong station and the Island Line at Fortress Hill station. This line is needed in the medium term to relieve congestion on the Island Line.

#### *Kwun Tong Line Extension*

Following a request by the Government in November 2003, the Company submitted an initial proposal in February 2004 and a revised proposal in July 2005 for an extension of the Kwun Tong Line from Yau Ma Tei station to Whampoa. The proposal is currently under review by the Government.

***Tseung Kwan O South Station***

Construction commenced in 2006 on a new station on the Tseung Kwan O Line at Tseung Kwan O South and is due for completion in the first half of 2009. This station will serve the Company's property development currently under the construction at Area 86 and adjacent to the Tseung Kwan O Depot.

## STATION COMMERCIAL AND OTHER BUSINESSES

The Company continues to leverage off its railway assets to derive revenue from the station commercial and other businesses which include the leasing of advertising media, station kiosks in MTR stations, and from the enabling of telecommunication services within the MTRC Railway. From time to time, the Company also derives income from other passenger services, such as the sale of MTR souvenir tickets.

### Advertising

MTR Advertising has been established for over 25 years to generate non-fare revenue for the Company while keeping passengers entertained and informed of updated products and services. The Company continued to enhance the attractiveness of its advertising media through the introduction of innovative formats such as Trackside TV Advertising, Station Pillar and Wall Advertising, InfoPanels and Passenger Information Display Systems inside refurbished trains and stations, Spectacular Mobile Showcase, Real Time Projection Zone and Plasma Ring. These advertising opportunities are in addition to the popular poster panels which total to about 19,000 in MTR and Airport Express systems.

### Telecommunication

The Company entered into agreements with mobile operators in Hong Kong to provide mobile coverage within the MTRC Railway. In addition to providing convenience to travelling passengers, it is also a continuing source of income to the Company. Passengers enjoy the convenience of making telephone calls and accessing to the internet and other data services via their mobile handsets. There are about 0.9 million telephone calls made within the MTRC Railway every day and the total call minutes is around 1.9 million minutes daily. Besides voice calls, there are also increasing usage of data services, such as Short Message Service, within the MTRC Railway.

On 2 June 2003, the Office of the Telecommunications Authority issued a fixed-line telecommunications license to TraxComm Limited, a wholly-owned subsidiary of the Company established in 2002, to develop a wholesale fixed-line telecommunications business based on the Company's existing fibre-optic infrastructure. In 2003, TraxComm Limited built and began to operate an enhanced network, which runs alongside the existing fibre-optic network. TraxComm Limited has sold more than 180 Gbps of bandwidth services to a number of customers, despite its relatively short operating history. Throughout the years, TraxComm Limited has continued to extend the reach of its fibre-optic infrastructure to date centers and commercial buildings.

### Station Commercial

There are over 580 shops at MTR stations providing a number of convenience commuter services.

To further enhance customer experience in travelling on the MTRC Railway, a major refurbishment programme commenced in 2001 to introduce more shops and improve the retail zone environment. Through continuous upgrading of shops and its environment, and active management of the trade mix of the shops, the Company has seen growth in this business. So far, 40 stations have been renovated. More stations are being planned for the shop refurbishment works with the next ones to be Kowloon, Sai Wan Ho and Lai Chi Kok Stations which are scheduled to complete for opening by end-2007. The new shops at Kowloon Station are now available for letting.

### Ngong Ping 360

The Tung Chung Cable Car project, which is owned by the Company, is branded "Ngong Ping 360" and is managed and operated by Skyrail-ITM (Hong Kong) Limited, a third party contractor. Ngong Ping 360 opened on 18 September 2006. In June 2007, during the annual testing outside of operation hours, one of the gondolas detached from the cable. There were no injuries and operations immediately ceased and detailed investigations followed. The Company and EMSD will only permit resumption of passenger operations of the cable car system once it and EMSD are completely satisfied with all safety aspects of the system.

### Octopus Holdings Limited

The Company launched the Octopus Card in 1997. Since then, the contactless Octopus Card has become so popular in Hong Kong that over 15.4 million Octopus cards are being actively used by the territory's approximately 7 million people. Octopus Card is widely accepted not only by the different modes of public transportation, but also certain convenience stores and supermarkets as well as fast food restaurants.

The Octopus Card is owned by Octopus Cards Limited which is a non-controlled, indirect subsidiary of the Company. The Company currently owns 57.4% of the issued share capital of Octopus Holdings Limited, which owns 100% of the issued share capital of Octopus Cards Limited, with the remaining 42.6% of the issued share capital of Octopus Holdings Limited owned by KCRC, KMB Public Bus Services Holdings Limited, Citybus Limited and New World First Bus Services Limited. Although the Company holds 57.4% of the issued shares of Octopus Holdings Limited, the Company's voting rights at board meetings of Octopus Holdings Limited are limited to 49% and none of the shareholders of Octopus Holdings Limited is able to control the board of directors of Octopus Holdings Limited unilaterally.

### External Consultancy

The Company offers consultancy services in various areas of expertise including, but not limited to, railway planning, construction project management, operation, maintenance, asset upgrades as well as railway related property advisory work. The strategy for the consultancy business remains focused on key cities where such work may lead to investment opportunities in the Mainland or in Europe, or consultancies which can enhance the skill sets of the Company's staff.

## PROPERTY

### Property Development

Property development is a significant part of the Company's business, providing an important source of income that has supported the cost of construction of railway projects as well as contributing to future rail patronage from the immediate catchment areas created by property developments.

In conjunction with its railway construction activities, the Company has been involved in the development of residential and commercial properties above and adjacent to MTR stations and depots under agreements with various property developers. Profits that the Company has received from these development ventures have been used by the Company to supplement associated railway returns, thereby contributing to an improved rate of return on the investment of constructing new railway lines.

The Company has an established track record for the planning, designing and project management of railway property developments. The Company's formula for property development is based on minimising direct risk in the development of the properties, thereby reducing the Company's exposure to the property market and its related risks.

The Government has granted the Company the development right over the land used for property developments based on a land premium assessed at full market value without regard to the presence of the railway on the sites being valued. The Company's practice in property development has been to arrange for various third-party developers to carry out the actual development works according to the Company's specifications. Typically, the developers are responsible for all development costs (including Government land premium, construction and enabling work costs, marketing and sales expenses, professional fees, finance charges and other expenses), and have to bear all development risks. The Company derives benefit from property developments through the sharing of profits with developers in agreed proportions from the sale or lease of the properties after deducting the development costs, the sharing of assets in kind, or through up-front payments from the developers.

#### *Property developments related to the Airport Railway (the Tung Chung Line and Airport Express)*

There are five Airport Railway development sites comprising 15 tender packages, all of which have been awarded to developers following competitive tendering processes. The total development gross floor area related to the five development sites amounted to approximately 3.5 million square metres. These developments have been, or are expected to be, completed between 1998 and 2010.

***Property development related to Tsing Yi station***

Planning continues for Tsing Yi Town Lot No. 135 adjacent to Tsing Yi station, which is currently used as a public transport interchange and a lorry park. A planning application was submitted to the Town Planning Board in July 2006 and approved in September 2006 to facilitate the inclusion of retail use in the site. The scheme will further enhance the integration with different modes of transport. The land application procedure has begun.

***Property developments related to the Tseung Kwan O Line***

The Company has the right to undertake property development at four locations along the Tseung Kwan O Line. The Company plans to divide the developments at Tiu Keng Leng, Tseung Kwan O, Hang Hau and Area 86 into up to 18 development packages, completion of which is anticipated by 2015. The expected total investment cost, the bulk of which is planned to be borne by developers, is approximately HK$113 billion based on 2006 prices.

The signing of the Agreement for Lease for Tseung Kwan O Town Lot No.70 in May 2002 marked the Company's first step towards developing its depot site at Area 86. The extensive development with up to 13 phases is expected to contain, on completion in 2015, some 21,500 flats set in a garden environment.

In 2000, the Company entered into a development agreement with a developer consortium in relation to the development of Area 57a adjacent to Tseung Kwan O station. In January 2002, the Company awarded the Area 55b development site, which is located adjacent to Tseung Kwan O station in the heart of Tseung Kwan O town centre. The sold residential units at "Central Heights" (Area 57a) and "The Grandiose" (Area 55b) have been completed and delivered to purchasers. In June 2002, the Company awarded a property development package in Hang Hau station to a developer consortium. All residential units have been sold.

In October 2002, following a public tender process, the Company awarded Tiu Keng Leng station development to a property developer. The first phase (Metro Town Towers One, Two, Three and Five) and second phase (Le Point) of the development at Tiu Keng Leng station were put on the market for pre-sale of its residential units in August 2005 and August 2006 respectively. Sold residential units for the first phase have been completed and handed over to purchasers. The retail centre of the development was also sold in November 2006 to a subsidiary of Cheung Kong (Holdings) Limited

The Company started launching the remaining development packages in December 2004, with completion of the final development package expected in 2015. For Area 86, which forms the bulk of the Company's land bank in Tseung Kwan O, the Company made the first package available for development in December 2004. In return for more competitive tenders, the Company agreed to pay half of the land premium for the first package and, on 18 January 2005, the Company awarded this tender. The second package was made available for development in December 2005 and, on 1 February 2006, the Company and Rich Asia Investments Limited, a subsidiary of Cheung Kong (Holdings) Limited, entered into an agreement for the development. The Company has agreed under the development agreement for the second package to extend a HK$4 billion interest-free loan to the developer in return for an increased sharing in kind of the development.

At Area 56, adjacent to Tsueng Kwan O station, the Company submitted a proposal to the Town Planning Board for a mixed commercial and residential development in January 2005. A revised scheme to develop a hotel, residential, office and retail complex was submitted to the Town Planning Board and was subsequently approved in December 2005. Tender was awarded to Lansmart Limited, a subsidiary of Sun Hung Kai Properties on 15 February 2007.

**Property Investment**

The Company has an active portfolio of investment properties, selectively chosen from its development projects. These investments contribute recurrent income and enhance the Corporation's asset base. Additions, such as the new majority owned shopping centre at Tseung Kwan O, The Edge, with a lettable floor area of 7,683 square metres, have enabled the Company to capitalise on the positive factors in the retail environment such as stronger consumer demand, an improved employment market, the positive wealth effect from the stock market rally, as well as tourism development. Other recent additions to the Company's portfolio include a wholly owned wet market with a lettable floor area of 508 square metres which opened in Tung Chung in February 2007 and Phase 1 of Elements, a majority owned upscale mall with gross floor area of 82,750 square metres at Kowloon Station, which is expected to open by the end of 2007. In total as at the end of 2006, the Company's attributable share of the overall investment property portfolio comprises 133,927 square metres lettable floor area of retail properties, 39,529 square metres lettable floor area of offices and 1,460 square metres lettable floor area of other usage. The Property Valuation Report contained in the Appendix to this Circular headed "Property Valuation Report on the Enlarged Group" has details of the Company's specific property investments.

### Property Management and other Services

As at the end of June 2007, the Company managed a total of 61,214 residential flats and approximately 583,372 square metres of office and retail space. In 2000, the Company established a new service brand, Premier Management Services, for the management of selected high-end properties, including Two IFC and The Arch. The Company is developing property consultancy and management businesses in the Mainland and in this respect entered into new contracts for the management and provision of advisory services to up-market property developments in different parts of China. In 2006, three new property management contracts for luxury office/commercial developments were committed by SOHO China Ltd, all located in Beijing's central business district including SOHO Shangdu, Jian Wai SOHO Phase 7 and Chao Wai SOHO. In the first half of 2007, a memorandum of understanding was signed in relation to two offices and commercial developments in Beijing, one at Guanghua Lu and the other at Xidan. Also in Beijing, the Company entered into a long-term head lease for the operation and property management of Ginza Mall, a 19,295 sq m lettable shopping centre and the mall was opened in January 2007.

## OVERSEAS GROWTH

Expansion into markets outside Hong Kong is part of the Company's growth strategy. The strategy is to pursue metro investment opportunities in the Mainland, while pursuing "asset-light" railway operating franchises in Europe.

### Mainland of China

In 2006 the Company signed a concession agreement for the RMB15.3 billion BJL4 project with the Beijing Municipal Government. This marked an important milestone in the Company's overseas growth strategy. Approximately RMB4.6 billion, or 30% of the total cost, is being borne by a Public Private Partnership (PPP) company which is 49% owned by the Company, 2% by Beijing Infrastructure Investment Co., Ltd. and 49% by Beijing Capital Group. The balance of the capital cost will be funded by the Beijing Municipal Government. The PPP company will invest in the electrical and mechanical railway systems and the rolling stock, and operate the line for 30 years. Contracts for the rolling stock, signalling and automatic fare collection systems have already been awarded, and 23 of the 24 stations are now under construction. Construction is expected to be completed by 2009.

In Shenzhen, the Company awaits final approval from the National Development and Reform Commission on the RMB 6 billion Shenzhen Metro Line 4 project to build Phase 2 of the line and to operate Phases 1 and 2 for 30 years following agreement with the Shenzhen Municipal Government on a "Rail and Property" based financing model. Related utilities diversion and land resumption have begun. Initial preparatory work is near completion and major civil work is ready to begin.

While making progress on these projects, the Company has been pursuing other similar projects in key cities such as Shenzhen, Beijing, Hangzhou, Wuhan and Suzhou.

### Europe

In January 2007, the Company's joint bid with Laing Rail for the London Rail Concession (LRC) entered the final stages of the selection process as one of two remaining bids and a Best and Final Offer was submitted in March 2007. In June 2007, Transport for London (TfL) awarded the London Rail Concession (now renamed "London Overground") to the joint venture between the Company and Laing Rail. Commencement of operations are expected to start on 11 November 2007. The concession will run for 7 years, with an option for a 2-year extension at TfL's discretion.

## INTRODUCTION

The first section of the KCRC Railway opened in 1910. KCRC was created on 24 December 1982 for an unlimited duration by the KCRC Ordinance as a statutory corporation to operate, extend and improve railways in Hong Kong. The entire issued share capital of KCRC is held by the FSI on behalf of the Government.

The assets, rights and liabilities of the then existing Kowloon-Canton Railway were vested in KCRC by the Government on 1 February 1983. KCRC has two core operating divisions: Transport and Property.

## TRANSPORT

### THE KCRC Railway

KCRC's Transport division operates East Rail (including MOS Rail), West Rail, bus, Light Rail and intercity and freight services.

***East Rail***

The East Rail line is a 53.9km railway with 23 stations, including the Tsim Sha Tsui Extension, MOS Rail and LMCSL. Passenger services on the East Rail main line are provided by 37 electric multiple units of 12 cars each, and services on the MOS Rail are provided by 18 electric multiple units of four cars each. In 2006, the punctuality rate on the East Rail main line was 99.82% and ticketing equipment availability rate was 99.92%. MOS Rail is an 11.4km railway with an interchange at Tai Wai and eight other stations. In 2006, the punctuality rate on this line was 99.94% and ticketing equipment availability was 99.93%.

In 2006, East Rail's domestic passenger ridership was 677,000 passengers a day and average cross-boundary patronage was 241,000 passengers a day.

The LMC Spur Line opened for passenger operations on 15 August 2007 and consists of 5.2 kms of tunnels and 2.2km of viaducts. It branches off the existing East Rail alignment north of Sheung Shui Station, runs in tunnels from Sheung Shui to Chau Tau, and then rises gradually onto viaducts until it reaches a new station at Lok Ma Chau. In addition, the LMC Spur Line Terminus is linked to Huanggang Station of the Shenzhen Metro by a double-decker passenger bridge.

*Cross-Boundary and Through Train Services*

KCRC is responsible for operating local and cross-boundary passenger services from Lo Wu and Lok Ma Chau to East Tsim Sha Tsui (and, upon commencement of operations on the KSL, the Company will be responsible for operating these services to Hung Hom) on its East Rail line. KCRC also operates through train services to and from Guangzhou on its double decker "Ktt" train (the "**Guangzhou-Kowloon Through Trains**") and provides access for other through trains operated by Mainland railway operators or authorities running to and from six cities in the Mainland, namely Dongguan, Guangzhou, Foshan, Zhaoqing, Beijing and Shanghai. In 2006, the average daily patronage of through trains was 8,970 passengers.

As Lo Wu is in a restricted area near the boundary between Hong Kong and the Mainland, to which KCRC has exclusive access on the Hong Kong side, KCRC has, in previous years, enjoyed the benefits of increasing cross-boundary traffic. Lo Wu, directly across the boundary from Shenzhen's downtown area, is the most convenient boundary crossing for travellers going to Shenzhen for business or shopping. Therefore, KCRC has been able to charge passengers travelling to Lo Wu a premium fare. The current domestic fare on a single journey ticket from East Tsim Sha Tsui Station to Sheung Shui Station (the last station before Lo Wu) is HK$12.5 one way, compared to the cross-boundary fare of HK$36.5 from East Tsim Sha Tsui Station to either Lo Wu or Lok Ma Chau.

KCRC operates the only Hong Kong railway that connects with the Mainland's rail network. In 2006, the scope of the Individual Visit Scheme, under which a traveller from the Mainland may visit Hong Kong on an individual basis without a business visa or as part of a group tour, was further extended to cover six more cities (Nanchang, Changsha, Nanning, Haikou, Guiyang and Kunming). To tap the full potential of this market, KCRC partnered with business associates for providing special offers to Mainland travellers coming to Hong Kong by the Guangzhou-Kowloon Through Trains. Other joint promotions included offers on hotel packages and entertainment attractions, as well as discounts provided by certain retailers.

*Facility Improvements*

KCRC has recently undertaken several improvement projects to further provide quality service to its passengers. At Sheung Shui Station, KCRC extended the concourse to increase passenger-handling capacity in preparation for the opening of the LMCSL in August 2007. Also at Sheung Shui, KCRC began constructing noise barriers along the line, for the purposes of reducing the impact of train noise on nearby residents. At Hung Hom Station, KCRC started remodelling works in preparation for its new role in 2009 as the interchange for East Rail and West Rail. Track works and the planning for the construction of interchange facilities were both well underway. The Tai Po Market Station Refurbishment Project was another station improvement project that KCRC has commenced and this project is planned to be completed in 2007. Phase II of the Lo Wu Station Improvement Project has also made good progress. KCRC has further expanded and renovated the station platforms and installed new escalators and travellators. The upgraded station should be able to handle 25,000 passengers per hour per direction compared with the existing 22,000 passengers.

*Operations*

In 2006, the East Rail main line (excluding the MOS Rail) maintained a train service delivery rate of 99.85%, and a train punctuality rate of 99.82%. The number of passengers and members of the public injured per million passenger journeys on East Rail was 0.78 in 2006. In 2006, MOS Rail achieved a train service delivery rate of 99.95% and a train punctuality rate of 99.94%. The number of passengers and members of the public injured per million passenger journeys on MOS Rail was 0.5.

*Fare Promotions*

KCRC maintained 16 interchange discount routes with Green Mini-buses ("**GMB**") during 2006 to improve connectivity and thus enhance the value of its journeys. The East Rail One-Month Pass was extended. KCRC offers a wide range of travel-related products to stimulate leisure travel on its trains. Most travel packages, including packages for Ocean Park and Macau, came with either a Lo Wu two-ride travel pass or a domestic one-day travel pass. KCRC provided a regular bus service to Hong Kong Disneyland for cross-boundary passengers and extended such travel offer to the domestic market in 2006. Together with the Hong Kong Tourism Board, KCRC offered other promotions for discounts on selected travel products for Mainland and overseas tourists. To capture the MICE (Meetings, Incentives, Conferences and Exhibitions) market, KCRC has also launched bus services to Hong Kong Convention and Exhibition Centre and Asia World Expo during major events.

***West Rail***

West Rail is a mass transit commuter rail line linking suburban areas along the northwestern corridor of the New Territories to the Kowloon urban area. It is designed to resolve the long-standing transport problems for residents in the north-western New Territories by linking West Kowloon with Tuen Mun in the western New Territories. West Rail has nine stations with a 30.5km railway, and operates on an electrically-powered rail system that is environmentally friendly.

West Rail was officially inaugurated on 20 December 2003 and full passenger operations commenced on that date. Passenger services on West Rail are provided by 22 electric multiple units ("**EMUs**") of seven cars each, and are anticipated to be increased to nine-car EMUs as ridership increases and demand grows. West Rail reduces commuters' travelling time from the north-western New Territories to urban Kowloon by half, with a complete journey from one end of the alignment to the other taking less than 30 minutes. In 2006, ridership was a daily average of 200,100, punctuality rate was 99.88% and ticketing equipment availability rate was 99.96%.

West Rail is connected to the MTRC Services at two junctions, namely the Tsuen Wan line at Mei Foo Station, and the Tung Chung line at Nam Cheong Station. West Rail is also connected to Light Rail at Yuen Long, Tin Shui Wai, Siu Hong and Tuen Mun stations. Further, public transport interchanges at most stations allow passengers to transfer conveniently between various kinds of feeder transport services. It is anticipated that West Rail will be an important service link for passengers upon the completion of the KSL, which is planned for completion in 2009, when passengers will be able to transit through Tsim Sha Tsui to Hung Hom Station.

*Facility Improvements*

KCRC has carried out major upgrades to the West Rail signalling system to ensure greater reliability and improve its handling of incidents. These included improvements to the power supply and earthing equipment as well as the signalling equipment software on the trains. As a result, the number of delays exceeding eight minutes was reduced from 26 in 2005 to 13 in 2006. To further improve the reliability of West Rail operations, a second dedicated 11kV power supply for the operations control centre and the computer centre at the West Rail Building (in Kam Tin, New Territories) was substantially completed for commissioning in early 2007.

Recent improvements have also been carried out at various West Rail stations. KCRC enhanced station signs and installed additional seats at platforms, handrails on wide staircases and canopies at Tuen Mun Station and Tsuen Wan West Station. KCRC has also constructed rain shelters at the entrances of Tin Shui Wai Station and Tuen Mun Station for the safety and convenience of its passengers.

*Operations*

In 2006, West Rail maintained a train service delivery rate of 99.91%, and a train punctuality rate of 99.88%. The number of passengers and members of the public injured per million passenger journeys on West Rail was 0.51 in 2006.

*Fare Promotions*

KCRC has undertaken a number of measures to increase patronage on West Rail. It extended the One-Month Pass and the One-Day West Rail Discovery Pass, as well as the HK$2 weekend concessionary fares for children and senior citizens. KCRC continues to build ridership on the interchange discounts for those West Rail passengers travelling on some GMB routes and franchised buses. By offering free feeder services to West Rail and the Light Rail, KCRC's buses have also continued to play an important role in increasing the service catchment of its railway stations. Some of the leisure related products that KCRC provided, such as the Ocean Park Combo, which includes daytime admission to Ocean Park and free shuttle bus to/from Ocean Park, have also been extended to West Rail.

***Light Rail***

KCRC's Light Rail system (which is also known as the North-west Railway) commenced operation in September 1988, comprising 36.2km of double track with 68 stops. As of 31 December 2006, the Light Rail system operated within the areas of Tuen Mun, Yuen Long and Tin Shui Wai in the north-western New Territories. It is a regional mass-transit system utilising vehicles, which are similar to trams on tracks that run parallel to public roads. As an important element of the integrated transport system in the north-western New Territories, Light Rail has assumed greater importance as a complementary service for West Rail. At the end of 2006, KCRC had 119 Light Rail vehicles. In 2006, the Light Rail vehicles recorded a punctuality rate of 99.92% and a ticketing equipment availability rate of 99.96%.

Since 2003, KCRC has reorganised its Light Rail and bus services in order to provide a more efficient feeder service to enhance public access to West Rail stations and provide the public with additional incentives to use West Rail for internal and external travel. KCRC recorded a daily average of 373,800 passenger-trips on the Light Rail during 2006. In the north-western New Territories public transport market, the Light Rail system has for many years enabled KCRC to be the major operator.

KCRC introduced a service improvement scheme in October 2006 to deploy some of its resources from the long haul Light Rail routes to the local Light Rail routes. Accordingly, KCRC "turned short" one long haul route from Tin Shui Wai North to Yuen Long by merging two routes — the 761 and 761P. KCRC also cancelled one bus route to save the resources that can then be allocated to two other routes.

KCRC has also commissioned a new Passenger Information System for the Light Rail and installed new Passenger Information Display Units in the West Rail Siu Hong Station and Tin Shui Wai Station concourses for passengers interchanging to the Light Rail.

KCRC has undertaken a number of recent improvements on Light Rail. For the convenience of wheelchair passengers, KCRC relocated and shortened 44 Platform Contactless Smartcard Processors on 22 platforms at 12 stops. KCRC also improved the Light Rail platform environment by installing benches, stop signs and passenger notices. To improve the reliability of the system, KCRC completed the signalling system upgrade for the Light Rail in mid-2006. In addition, the Light Rail control centre was expanded in 2006 to accommodate a modern control panel and a fault reporting centre.

To enhance passenger safety awareness, a series of promotional events were held in 2006. The key messages conveyed at these promotions focused on discouraging trespassing onto railway tracks, encouraging the safe use of escalators and reminding passengers to be aware of platform gaps at stations. In particular, a safety campaign devised specifically for the Light Rail was held to educate road users on the traffic regulations at the Light Rail crossings.

***Bus Operations***

KCRC established bus operations in 1986 to provide efficient feeder bus services to the Light Rail system and East Rail. As of 31 December 2006, KCRC operated 14 feeder bus services excluding East Rail feeder services. KCRC's entire 143 vehicle bus fleet (including feeder buses) is now air-conditioned. Nine new environmentally friendly double-deck buses "Alexander Dennis Trident Enviro 500s" and eleven more single-deck buses "Alexander Dennis Dart Enviro 200s" will be delivered to Hong Kong in 2007 and 2008 to replace some of the buses that will retire in the next two years. The buses provide the highest level of passenger comfort while meeting strict environmental and safety standards. KCRC is the first transport corporation in Hong Kong to introduce buses fitted with the Euro IV engine and meet the latest environmental requirements passed in October 2006.

KCRC is not entitled to charge fares on its feeder bus services in the north-western New Territories outside the Transit Service Area. KCRC entered into a commercial agreement with Kowloon Motor Bus in May 1999 to run East Rail feeder bus routes to Tai Po, Shatin, Fo Tan and Hung Hom. As of August 2007, there are five such routes. This arrangement enables KCRC to generate revenues (from fares charged by Kowloon Motor Bus) from passengers who use the bus services but do not connect to East Rail and, by indirectly benefitting from fuel tax concessions given to franchised bus operators such as Kowloon Motor Bus, to reduce costs. The auxiliary bus routes are stand-alone routes, which charge a separate fare and to which the discount for transfer within KCRC's rail network is not applicable. Only one auxiliary route is now in operation.

The average daily bus ridership during 2006, excluding the six feeder routes for East Rail run by Kowloon Motor Bus, was 82,400.

***Freight Services***

Freight services, operating on the same track as East Rail passenger services, convey cargo by rail between Hong Kong and the Mainland. KCRC also provides ancillary terminal services. KCRC carries three main types of cargo: (i) containers; (ii) break-bulk, which comprises mainly mail, textile fibres, foodstuffs, metals, paper and chemicals; and (iii) livestock.

KCRC currently operates container and breakbulk services to all major cities in the Mainland.

Rail-borne freight, both breakbulk and containerised, either originates in Guangdong Province or reaches Guangdong Province mainly from the interior provinces of the Mainland. From Pinghu in the Mainland, rail-borne freight is distributed to Yantian, Shekou in Guangdong and Hong Kong. Yantian and Shekou, which are container terminals near the boundary in the Mainland, are competitive threats to Hong Kong transhipment services as Chinese exporters have been choosing these ports as they offer lower terminal handling charges than Hong Kong and have a shorter transit time. However, the lack of infrastructural support compared to Hong Kong makes these ports comparatively less attractive to many shippers, although such ports are becoming more competitive.

The livestock freight service is a longstanding business for KCRC but carries a low margin and has generated low profit, and there is a general market trend away from breakbulk freight services in favour of containerised freight services, which are more attractive to customers.

***Kowloon Southern Link***

The Kowloon Southern Link, a 3.8km railway, will run along Canton Road and link East Tsim Sha Tsui Station to the West Rail Nam Cheong Station, joining KCRC's two major railway lines at the southern end. On completion, West Rail will be extended from Nam Cheong Station to Hung Hom Station via West Kowloon and Tsim Sha Tsui, and both East Rail and West Rail will terminate at Hung Hom with convenient cross-platform interchanges provided. This project will integrate East Rail and West Rail, creating a unified rail network. Construction on the Kowloon Southern Link commenced on 7 November 2005.

***Northern Link and Express Rail Link***

In February 2006, the Government invited KCRC to proceed with further planning for the Northern Link and the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link as a combined project.

The Northern Link will extend KCRC's rail network from the West Rail Kam Sheung Road Station to Lok Ma Chau. As a natural extension of KCRC's network, it will provide a cross-boundary link for West Rail. By joining the northern sections of West Rail and East Rail, it will also create a new railway corridor between the north-eastern and the north-west New Territories.

The 30km Hong Kong section of the Express Rail Link will start at a new terminus at West Kowloon. Various alignment options are being considered to link this terminus with a cross-boundary tunnel that will connect to the Mainland section of the Express Rail Link at the boundary at Huanggang. When completed, the Express Rail Link will become part of the national express rail network linking the Mainland rail hubs at Longhua in Shenzhen and Shibi in Guangzhou.

Separate Northern Link and Express Rail Link Project proposals were submitted to the Government in June 2007.

***Shatin to Central Link***

In 2002, KCRC was selected to proceed with the planning of the SCL project and, in 2004, submitted its draft final proposal ("**DFP**") to the Government. The DFP included the extension of East Rail across Victoria Harbour to Hong Kong Island and the extension of the Ma On Shan Rail to West Rail via East Kowloon. Alongside the planning for the SCL, the Government invited the Company and KCRC to discuss the Rail Merger in 2004. One of the parameters set by the Government for the merger discussion was the early resolution of the interchange arrangements for the SCL. Subsequently, the Company and KCRC jointly developed a SCL scheme to be implemented under the merger scenario ("**Merger Scheme**") and submitted a project proposal on the SCL scheme to the Government in July 2005. KCRC's DFP and the Merger Scheme developed by the two railway corporations are broadly similar in terms of the railway alignment.

Government has stated that since the SCL scheme proposes to locate a station at Kai Tak and an Exhibition Station at Wan Chai North, the implementation programme for the SCL will be dependent on the progress of the current Kai Tak Planning Review in finalising the development plan for Kai Tak and the Wan Chai Development Phase II Review in finalising the scheme for the Central-Wan Chai Bypass.

According to the Transport and Housing Bureau, the SCL remains a committed project for implementation. It stated in a paper to the Legislative Council Panel on Transport dated 16 July 2007 (LC Paper No. CB(1)2058/06-07(01)): "*We will closely monitor the latest development of the Kai Tak Planning Review and the Wan Chai Development Phase II Review, and continue to stay in touch with the LegCo, District Councils concerned and the local communities in finalising the implementation details for the SCL project. We would further discuss with the railway corporations on the funding and implementation details and consider whether to adopt the ownership approach or the concession approach for implementing the SCL. The Administration has promised to make a decision on the way forward, including the scheme and timetable for the SCL within six months after the completion of the legislative process for the rail merger*."

## PROPERTY DEVELOPMENT

KCRC's Property Division is composed of three departments, namely Property Development Department ("**PDD**"), Property Construction Department ("**PCD**") and Property and Commercial Services Department ("**PCSD**"). The property development projects along the railway lines are managed by PDD and PCD, and PCSD is responsible for managing the property services and commercial activities. The Property Division aims to maximise the use of railway land by developing properties jointly with property development companies and exploiting new revenue sources in order to generate profits that will help fund corporate strategic initiatives. In Hong Kong, properties located above or in the proximity of railway stations and depots remain in good demand owing to the access they provide to public transport systems.

### Arrangements with Developers

KCRC has been involved in joint development ventures with established property developers for the development of properties along its railway lines since 1985. In the case of property developments along existing railway lines, developers are invited to form joint ventures with KCRC. Joint venture partners are selected for each development based on their development experience, financial capability, track record and the terms and conditions of each joint venture proposed. Developers generally fund the cash development costs including land premium, construction costs and finance charges and bear substantially all development risks. In the case of West Rail and MOS Rail, KCRC may, in certain circumstances, undertake the construction works with respect to the necessary property development enabling works in conjunction with the railway works in order to preserve the development potential above railway lines. Developers will then be solicited to undertake the property developments. Profits from the developments, with the exception of West Rail property sites and proposed property sites along the Kowloon Southern Link, after reimbursement of development costs, are shared between KCRC and the developers. In certain instances, the minimum profit to KCRC has been guaranteed by the parent holding company of its joint venture partner. The level of profits in excess of any minimum profit guaranteed by the developer would be primarily determined by prevailing market conditions at the time. The development of the properties is managed by project coordination committees, usually with equal representation from both KCRC and its joint venture partner, but where KCRC has a casting vote. Control over the disposal of properties completed by the joint ventures is retained by KCRC, including decisions regarding whether to sell or lease the properties, the offer price and sale price if it decides to sell, and the lease terms if it decides to lease the properties.

KCRC undertakes the property developments in such manner and upon such terms as may be set out in the relevant private treaty grants and will be responsible for the necessary planning, design and construction of the property developments. For West Rail Property Development Limited ("**WRPDL**"), an intermediate holding company jointly formed by KCRC and the Government, profits from the property development, net of costs and expenses KCRC incurs in respect thereof, and net of any other development-related costs to be provided for in such arrangements, together with an on-cost of a specified percentage thereon, are for the account of the Government.

#### *East Rail Property Development*

Construction works on the Ho Tung Lau (Site A) project are in progress. The foundation works for the major residential towers were completed, and pre-sales for the residential units are scheduled in late 2007. KCRC's partner in the project is Full Fair Limited, a subsidiary of Sino Land Company Limited. This 2.67-hectare project is a residential/commercial development, providing 122,900 sq m of gross floor area. Ten 37- to 40-storey residential towers will be built on a two-level podium, providing around 1,375 residential units which are scheduled for completion in 2008.

#### *West Rail Property Development*

For West Rail, KCRC has identified 13 sites with potential for property development along nine stations. KCRC expects to provide a total gross floor area of about 24.3 million sq ft, 88% of which would be for residential use and the remainder for commercial use. Under its current tentative plans, these projects would supply a total of about 30,000 flats during the period from 2012 to 2018. As part of the agreement for the Government's injection of HK$29.0 billion of additional equity into KCRC to help fund the development of West Rail, KCRC acts as the Government's agent in the development of the property sites along West Rail, and the Government receives the net profits from the development of these projects, net of contingent expenses, development costs and other expenses to KCRC as provided in an agreement signed in February

2000 between the Government and KCRC. Thirteen subsidiary companies, wholly owned by WRPDL, were formed to implement the property projects for the 13 West Rail property sites (further details of the arrangement post-Rail Merger in relation to property development of West Rail sites contained in the paragraph headed"West Rail Agency Agreement" in the Appendix to this Circular headed "Transaction Agreements").

Acting as the agent of Tuen Mun Property Development Limited, KCRC awarded the joint venture tender for the West Rail Tuen Mun Station development to Wetland Park Management Service Limited, a subsidiary of Sun Hung Kai Properties Limited. This project occupies an area of about 2.7 hectares and will have an approximate gross floor area of 145,000 sq m comprising 120,000 sq m for residential use and 25,000 sq m for retail purposes. Construction commenced in mid-2007.

***MOS Rail Property Development***

Along the MOS Rail alignment, four sites have been identified for priority property development. These four sites, namely Tai Wai Maintenance Centre (7.06 hectares), Tai Wai Station (4.85 hectares), Wu Kai Sha (3.41 hectares) and Che Kung Temple (1.81 hectares), are expected to generate about 11,000 residential flats, which equates to 92% of 830,850 sq m of gross floor areas to be built on these four sites. In accordance with the Government's property stabilisation measures announced in October 2003, these four residential developments are expected to be completed between 2009 and 2015.

Eleven tenders were received for the 7.06-hectare site above KCRC's Tai Wai Maintenance Centre adjacent to Tai Wai Station. KCRC signed a joint venture agreement with East City Investments Limited, a subsidiary of Cheung Kong (Holdings) Limited. With 12 residential blocks providing around 4,300 residential flats, this is the largest development project ever undertaken by KCRC. In August 2007, construction commenced. The project will be completed in three phases, with a scheduled completion date for the last phase in 2010.

The Wu Kai Sha Station joint venture project between KCRC and its joint venture partner, Shine Harvest International Limited, a subsidiary of Sino Land Company Limited, also made satisfactory progress during 2006. By end of 2006, the foundation works and detailed design of the building structure had been completed. The major building works commenced in mid-2007. The development (providing approximately 2,100 flats) is scheduled for completion by end 2008/early 2009. Pre-sale of the flats is expected to commence soon.

**Commercial Activities, Leasing and Property Management**

KCRC generates recurrent revenue from its properties located within its railway stations and in the proximity of its railway networks. These properties include a total station shop area including duty free of 24,658 sq m at East Rail (excluding Lok Ma Chau), the West Rail stations and the MOS Rail, an aggregate of 21,909 sq m of commercial office space at Citylink Plaza at Shatin Station, 5,576 sq m at the KCRC Hung Hom Building and an aggregate of 40,077 sq m of retail shopping space at five other sites, which are Sun Tuen Mun Shopping Centre, Citylink Plaza, Plaza Ascot, Hanford Plaza and Ocean Walk (formerly Pierhead Plaza). KCRC continues to diversify the trade mix found in its stations, where sources of income include leasing of space for retail shops, restaurants and offices, as well as licensing of duty-free businesses, car parks, advertising, telecommunications and exhibitions. In some cases, KCRC has negotiated arrangements with the operators for rents that are linked to their sales turnover. In terms of estate management, as of 31 December 2006, KCRC managed a total of 9,854 residential flats, 3,457 car park spaces and 91,028 sq m of commercial floor area along the railway lines of East Rail and West Rail networks.

KCRC has been seeking opportunities to expand its retail areas in stations. For example, in 2006 KCRC added around 240 sq m of shop space at Sheung Shui Station and Lo Wu Station. Renovation works in these two stations are still in progress and an additional 300 sq m of station space is expected to be created in 2007. Similarly, in mid-2006, KCRC commenced renovation works at Tai Po Market Station to provide an additional 300 sq m in 2007. KCRC also plans to increase the retail area at Mongkok Station. Renovations will take place throughout 2007, which is expected to provide an additional area of around 500 sq m. More than half of the tenancies in West Rail stations expired at the end of 2006, three years after the opening of the railway line. Some of the tenants could not maintain their operations and, as a result, the occupancy rate of West

Rail shops decreased to 80% at the end of 2006. To improve the situation, KCRC has adopted a flexible leasing strategy with a view to filling as many shops as possible. For the new LMC Spur Line, KCRC has provided space for 69 new shops (not including the new duty free operation) at the new terminus. More than 80% of the shops were pre-leased by the end of 2006, with a wide mix of tenants to serve domestic and cross-boundary passengers.

KCRC has completed the renovation work at Ocean Walk in Tuen Mun with a total area of around 10,000 sq m. KCRC has also now disposed of all premises at Manlai Court, including five retail shops and three carparking spaces, as part of a continuing evaluation of its existing investment property portfolio.

In addition, KCRC has launched Newsline Express, Hong Kong's first on-train quasi-real-time audio-visual system.

## THE GOVERNMENT AS SHAREHOLDER

### The Government's shareholding

As at the Latest Practicable Date, the share capital of the Company is owned as follows:

| Shareholder | Number of Shares | Approximate Voting Power (%) |
|---|---|---|
| FSI[1] | 4,285,040,314 | 76.67 |
| Other Investors[2] | 1,303,667,191 | 23.33 |

*Notes:*

(1) The Financial Secretary Incorporated holds these MTRC Shares in trust on behalf of the Government.

(2) Includes institutional and retail investors.

The Company has been informed by the Hong Kong Monetary Authority that, as at the Latest Practicable Date, approximately 0.94% of the MTRC Shares (not included in the FSI shareholding set out in the above table) 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. As further detailed in the paragraph headed "Connected Transactions and Continuing Connected Transactions" in this section of the Circular, Government and its associates will be required to abstain from voting with respect to the EGM Resolution.

The Rail Merger will not affect directly the above shareholdings.

### Control at shareholder meetings

For as long as the Government is the beneficial owner of the majority of the Shares, it will be able to pass ordinary resolutions on its own at general meetings of the Company. Ordinary resolutions are passed by a simple majority of members entitled to vote, and actually voting (in person or by proxy), at a meeting for which proper notice has been given in accordance with the Company's Articles of Association. Under Hong Kong law, all matters for a company may be decided by the passing of ordinary resolutions except those which, under the Companies Ordinance or a company's articles of association, specifically require the passing of a special resolution. Matters which, under Hong Kong law, are to be decided by the passing of a special resolution include the alteration of a company's memorandum of association and articles of association, the change of name of a company, a reduction of a company's share capital, a resolution of a company that it should be wound up by the court, the voluntary winding up of a company and approval of a scheme of arrangement. A special resolution is one which requires not less than three quarters of the votes cast by members, entitled to vote, who vote in person (or by proxy) at a general meeting of which not less than 21 days' notice specifying the intention to propose the resolution has been given. If the Government is the beneficial owner of at least 75% of the issued MTRC Shares it will be able to pass special resolutions on its own at general meetings of the Company.

To approve the resolution to be considered at the Merger EGM a simple majority of the members voting is required. The Government and its associates are not Independent Shareholders and will be required to abstain from voting with respect to the EGM Resolution as a connected person with a material interest in the Rail Merger.

### Control of the Board

The Company, in accordance with its Articles of Association, has the power to appoint persons to the Board by ordinary resolution. For as long as the Government is the beneficial owner of the majority of the issued Shares, it will be able to appoint persons to the Board on its own and, in addition, no other shareholder, or shareholders together, will be able to appoint persons to the Board unless the Government fails to vote its Shares against the appointment of such persons.

Under Section 8 of the MTR Ordinance, the Chief Executive may appoint, for a period he directs, not more than three persons to be "additional directors" of the Company. Persons appointed in this way may be removed from office only by the Chief Executive. In the event of any transaction, arrangement or other kind of proposal being considered by the Board, in which any additional director has a material interest including a material interest that arises as a result of the Government office which he holds, such additional director shall abstain from voting at the relevant meeting of the Board in accordance with the provisions of the Company's Articles of Association, which apply to all Directors. As at the Latest Practicable Date, only the office of the Secretary and the office of the Commissioner have been appointed as "additional directors" under Section 8 of the MTR Ordinance.

Under the Company's Articles of Association, for so long as the Government is the beneficial owner of the majority of the issued Shares, it will be able to appoint the chairman of the Company. The Government exercised this power in appointing Dr. Raymond Ch'ien Kuo-fung as chairman of the Company.

In addition, under the Company's Articles of Association, for so long as the FSI controls 50% or more of the voting power of the Company, it has the right to appoint and remove any non-executive Director as a member of each of the audit committee, nominations committee and remuneration committee.

**THE GOVERNMENT AS REGULATOR**

The Integrated Railway operations will be principally regulated under the MTR Ordinance and the Operating Agreement. A copy of each is available for inspection, as described in the paragraph headed "Documents Available for Inspection" in the Appendix to this Circular headed "General Information".

**CONNECTED TRANSACTIONS AND CONTINUING CONNECTED TRANSACTIONS**

In the following paragraphs under this section headed "Connected Transactions and Continuing Connected Transactions", the terms "**associates**", "**connected person**", "**connected transactions**" and "**continuing connected transactions**" have the meaning ascribed to them in the Listing Rules.

At the Latest Practicable Date, the Government is a substantial shareholder of the Company (through the FSI) and the sole shareholder of KCRC (through the FSI, making KCRC an associate of the Government for the purposes of the Listing Rules). Therefore, the Rail Merger and the entering into of the Transaction Agreements constitute connected transactions pursuant to the Listing Rules. As the Rail Merger falls outside the *de minimis* thresholds in the Listing Rules, it is subject to the approval of the Independent Shareholders.

Any connected person with a material interest in a connected transaction and any shareholder (together with its associates) with a material interest in the connected transaction, is required to abstain from voting on resolutions approving the transaction.

Accordingly, the Government as a connected person with a material interest in the Rail Merger is not an Independent Shareholder and (together with its associates) will be required to abstain from voting with respect to the EGM Resolution.

**The Existing Waiver**

The Company and its subsidiaries have entered into a range of transactions with the Government and its associates and it is expected that the Company and its subsidiaries will enter into similar transactions in the future. There is no assurance that, in relation to these transactions, the Company's interests or those of its subsidiaries will not conflict with the interests of the Government or any of its associates. These transactions can be categorised as follows:

- transactions with the Government entered into as a matter of law or regulation;
- operating agreements with the Government and its associates relating to the operation of the railway and ancillary facilities;
- project agreements with the Government relating to the construction of new railways or the extension of existing railways;
- agreements and transactions with the Government involving land and interests in land, including running line leases, land grants and leases;

- entrustment agreements with the Government and its associates under which one party, as entrustor, has appointed the other party, as entrustee, to construct specific types of infrastructure works;
- agreements with the Government in relation to treasury-related arrangements;
- purchasing agreements with the Government and its associates;
- miscellaneous agreements, transactions, arrangements and settlements with the Government and its associates; and
- transactions between (i) the Company, Octopus Holdings Limited ("**OHL**") and Octopus Cards Limited ("**Octopus Cards**") (and their respective subsidiaries); and (ii) KCRC, OHL and Octopus Cards (and their respective subsidiaries).

Given the unique nature of the Company, its business and its on-going dealings with the Government and its associates, at the time of the Company's initial public offering and listing on the Stock Exchange, the Stock Exchange granted a waiver to the Company from strict compliance with the requirements of the then Chapter 14 of the Listing Rules relating to the connected transactions, subject to certain conditions (the "**Existing Waiver**"). The Existing Waiver was renewed and updated in 2004 to reflect the amendments to Chapter 14 of the Listing Rules and the introduction of Chapter 14A. It was further updated in July 2005 to reflect the restructuring of Octopus Cards.

The Existing Waiver (as updated) was granted subject to certain conditions. The Existing Waiver provides that transactions with the Government entered into as a matter of law or regulation and operating agreements with the Government and its associates relating to the operation of the railway and ancillary facilities are not required to comply strictly with the Listing Rules that relate to connected transactions and continuing connected transactions. However, there are conditions in the Existing Waiver in relation to the other categories of connected and continuing connected transactions noted above. Under these conditions, amongst other things:

- where the Company would be required under Chapter 14A of the Listing Rules to comply with the reporting and announcement requirements (but not the independent shareholders' approval requirement), the Company is required to disclose in its annual report details of the relevant connected transaction or continuing connected transaction;
- where the Company would be required under Chapter 14A of the Listing Rules to comply with the reporting, announcement and independent shareholders' approval requirements, the company is required to make an announcement and disclose details of the relevant connected transaction or continuing connected transaction in its annual report and accounts;
- the Company is required to make the relevant transaction subject to the approval of the Board, with the Directors appointed by the Government under section 8 of the MTR Ordinance and any Director who holds a position in the Government being required to abstain from voting;
- in respect of any continuing connected transaction which is not exempted under the Listing Rules from any of the reporting, announcement and independent shareholders' approval requirements, (i) the Company is required to ensure that the independent non-executive Directors will review the transaction every year and confirm in the annual report that the transaction has been entered into in the ordinary and usual course of the business of the Company, either is on normal commercial terms or, if there are not sufficient comparable transactions to judge whether they are on normal commercial terms, on terms no less favourable to the Company than terms available to or from independent third parties and, in accordance with the relevant agreement governing them, on terms that are fair and reasonable and in the interests of the Shareholders as a whole, (ii) the auditors of the Company will provide a letter to the Board each year (with a copy to the Stock Exchange at least 10 business days prior to the bulk printing of the annual report) confirming that the transaction has been approved by the Board and has been entered into in accordance with the relevant agreement governing the transaction, (iii) the Company will allow, and use its reasonable endeavours to procure that the counterparty to the transaction will allow, the Company's auditors sufficient access to their records for the purposes of

giving their confirmations, (iv) the Company will state in its annual report whether the Company's auditors have given the confirmation referred to above, and (v) the Company will notify the Stock Exchange promptly and publish an announcement in the newspapers if it knows or has reason to believe the independent non-executive Directors and/or the Company's auditors will not be able to give the confirmations referred to above; and

- in respect of any connected transaction or continuing connected transaction which is not exempted under Rules 14A.31 or 14A.33 (as the case may be) of the Listing Rules, the Company is required to provide the Stock Exchange with a copy of the minutes of the Board meeting approving the transaction as soon as possible after the meeting and the minutes will reflect (i) whether or not the Directors consider the transaction to be on normal commercial terms and in the ordinary and usual course of business of the Company, (ii) the views of the independent non-executive Directors and (iii) whether any Director has a material interest in the transaction and, if so, whether he has abstained from voting at the meeting.

These conditions shall continue to apply to the connected transactions contemplated by the Existing Waiver.

It is a further condition of the Existing Waiver that the Company may not rely on it in the case of the Rail Merger. As such, in connection with the Rail Merger and in accordance with the Listing Rules, the Company:

- has provided the Stock Exchange with a copy of the minutes of the Board meeting approving the Rail Merger and the Transaction Agreements;
- has made an announcement regarding the signing of the Transaction Agreements;
- has issued this Circular to Shareholders and convened the Merger EGM;
- will require any connected person and its associates with a material interest in the Rail Merger and/or the Transaction Agreements to abstain from voting on the EGM Resolution;
- will ensure that the vote taken at the Merger EGM will be taken by poll;
- will announce the results of the poll; and
- will include in its next published annual report and accounts the details of the Rail Merger and the Transaction Agreements.

**The New Waiver**

As a result of the Rail Merger, the Company will, with effect from the Merger Date, be a party to a number of additional continuing connected transactions. These additional continuing connected transactions are not currently covered by the Existing Waiver because, as stated above, the Existing Waiver contains a condition that the Company is not permitted to rely on it for the purposes of the Rail Merger. Had it not been for this condition, the Existing Waiver (which pre-Rail Merger applies to, and covers, contracts entered into by the Company in respect of the MTRC Railway) would have applied to, and covered, the Rail Merger and the Transaction Agreements and the Company would not have needed to make an application to the Stock Exchange for a new waiver (which will apply to, and cover, contracts entered into by the Company post-Rail Merger in respect of the Integrated Railway) from strict compliance with Chapter 14A of the Listing Rules. Additional continuing connected transactions will arise after the Rail Merger with respect to the obligations of the Company under:

- the Merger Framework Agreement, other than those arrangements which will be fully implemented by the Merger Date;
- the Operating Agreement, including the requirement to operate the Integrated Railway in accordance with the Operating Agreement during the period of the Franchise as it relates to the Integrated Railway;
- the Service Concession Agreement, including the requirement to make the Concession Payments during the Concession Period;
- the KSL Project Management Agreement, which will continue until the construction of the Kowloon-Southern Link has been completed;
- the West Rail Agency Agreement, which will continue in force until the West Rail property developments have each been completed;

- the US CBL Assumption Agreements and the US CBL Allocation Agreement, which are each expected to last for the duration of the underlying CBLs;
- the Outsourcing Agreement, which will continue for a period of two years from the Merger Date;
- those existing contracts between KCRC and the Government (and/or its associates) which are vested by law in the Company; and
- the Property Package Agreements, which will contain the terms on which the relevant land and land interests will be held on an on-going basis.

Given the unique nature of the Company, its business and its on-going dealings with the Government and its associates, the Company has made an application to the Stock Exchange for a waiver to be granted from strict compliance with Chapter 14A of the Listing Rules. The application of the normal requirements of Chapter 14A of the Listing Rules to continuing connected transactions (the "**Normal Requirements**") arising as a direct result of the Rail Merger would, amongst other things, be impractical, result in a material interference with the operation of the Integrated Railway and in some cases would provide an additional layer of regulation to the regime already agreed and established with the Government. Recognising this and the unique nature of the Rail Merger regarding continuing connected transactions, the Stock Exchange has agreed to treat the connected transactions between the Company and the Government (and/or their respective associates) arising as a result of the Rail Merger in the manner described below:

- the Operating Agreement, the Memorandum on Performance Requirements and the Service Concession Agreement shall be subject to the approval of the Independent Shareholders, are described in the Appendix to this Circular headed "Transaction Agreements", shall be available for inspection (further details of which are contained in the paragraph headed "Documents available for Inspection" in the Appendix to this Circular headed "General Information") and otherwise shall be treated in the same way as the Existing Operating Agreement in that the Normal Requirements should not be applied;
- the Merger Framework Agreement, KSL Project Management Agreement, West Rail Agency Agreement (and related powers of attorney), US CBL Assumption Agreements, US CBL Allocation Agreement, the Outsourcing Agreement and the Property Package Agreements shall be subject to the approval of the Independent Shareholders, are described in the Appendix to this Circular headed "Transaction Agreements", shall be available for inspection (further details of which are contained in the paragraph headed "Documents available for Inspection" in the Appendix to this Circular headed "General Information") and otherwise shall be exempt from the Normal Requirements but shall be subject to the following conditions, which are substantially similar to the conditions of the Existing Waiver (the "**New Continuing Conditions**"):
  - In respect of a continuing connected transaction which would otherwise be subject to reporting, announcement and independent shareholders' approval requirements contained in the Listing Rules:
    - — the independent non-executive Directors will review the transaction every year and confirm in the annual report that the transaction has been entered into (i) in the ordinary and usual course of the business of the Company, (ii) is either on normal commercial terms or if there are not sufficient comparable transactions to judge whether they are on normal commercial terms, on terms no less favourable to the Company than terms available to or from independent third parties and (iii) in accordance with the relevant agreement governing them on terms that are fair and reasonable and in the interests of the Shareholders as a whole;
    - — the Company's auditors will provide a letter to the Board each year (with a copy to the Stock Exchange at least 10 business days prior to the bulk printing of the annual report), confirming that the transaction (i) has been approved by the Board; and (ii) has been entered into in accordance with the relevant agreement governing the transaction. The Company will allow, and use its reasonable endeavours to procure that the counterparty to the transaction will allow, the Company's auditors sufficient access to their records for the purposes of giving their confirmations and the Company will state in its annual report whether the Company's auditors have given the confirmation referred to above; and

— the Company will notify the Stock Exchange promptly and publish an announcement in the newspapers if it knows or has reason to believe the independent non-executive Directors and/or the Company's auditors will not be able to give the confirmations referred to above;

- in respect of any continuing connected transaction which is not exempted under the Listing Rules from the reporting, announcement and independent shareholders' approval requirement, the Company will provide the Stock Exchange with a copy of the minutes of the Board meeting approving the transaction as soon as possible after the meeting and the minutes will reflect (i) whether or not the Directors consider the transaction to be on normal commercial terms and in the ordinary and usual course of business of the Company, (ii) the views of the independent non-executive Directors and (iii) whether any Director has a material interest in the transaction and, if so, whether he has abstained from voting at the meeting; and

- in respect of those existing contracts between KCRC and the Government (and/or its associates) which are vested by law in the Company, the entry into of the Rail Merger (which, as a matter of law, includes the vesting of certain of KCRC's existing contractual arrangements) shall be subject to the approval of the Independent Shareholders, shall be described in the relevant statutory vesting notice made pursuant to the MTR Ordinance, and to the extent that the transactions of a continuing and connected nature under such contracts are not exempt under the Listing Rules from any of the reporting, announcement and independent shareholders' approval requirements, they shall be exempt from the Normal Requirements but shall be subject to the New Continuing Conditions.

**In considering whether or not to vote in favour of the EGM Resolution, the Independent Shareholders should consider all of the information contained in this Circular, including the following risk factors. Any of the risks described below could cause the financial performance of the Company to differ significantly from the goals, plans, objectives, intentions and expectations expressed in this Circular. If any of the following risk factors and uncertainties actually occur, the business, financial condition or operating results of the Company could be materially and adversely affected.**

## RISKS RELATING TO THE EXISTING BUSINESS OF KCRC

***Patronage and related fare revenue of the KCRC Railway may be susceptible to intensified competition as a result of changes relating to the ability of other transport providers to provide additional or cheaper services***

Competition from road-based modes of transport within Hong Kong, such as buses and residential coaches, is expected to increase further due to, amongst other things, the construction of new roads such as the Hong Kong-Shenzhen Western Corridor and Route 8 between Shatin and Cheung Sha Wan. The capacity of the new rail projects such as the LMC Spur Line and the Kowloon Southern Link may not be taken up by passenger growth for some time. The Company will therefore need to generate revenue from its and KCRC's existing customer base in order to react to any increased competition from other transport providers.

Although KCRC is the only rail operator providing passenger and freight rail services between Hong Kong and the Mainland, its passenger and freight services face competition from other transport providers, primarily operators of road and sea transport. Both the lower capital costs and market entry costs of KCRC's existing competitors might allow them to offer transportation services at lower prices and higher frequencies. As KCRC's profit depends heavily on its cross-boundary passenger service, the increase in the market share of its competitors would adversely affect KCRC's revenue growth. After the Rail Merger in order to maintain patronage levels, the Company might not be able to raise its fares on these services if competing service providers do not increase their fares. The intercity services will not be subject to the new Fare Adjustment Mechanism.

***There is only limited recourse contained in the Transaction Agreements in respect of defects or problems with the Concession Property.***

On 21 December 2005, a train servicer found that an underframe compressor mounted underneath a KCRC train that was currently in operation on East Rail appeared to be loose. This had occurred because of the formation of cracks in the welds of brackets holding the compressor to the train. During the examination that followed the incident, more cracks were discovered in the underframe equipment mountings of the same type of KCRC train cars operated on East Rail. KCRC's investigation eventually revealed that the cracks were the combined results of excessive vertical vibrations and welding imperfections of some of the underframe mounting brackets. To ensure it would not be repeated, KCRC started replacing the affected sections of rail, improving the train cars' suspension system to dampen vibrations and strengthening the brackets holding components to the underframe of the trains. KCRC has also installed newly developed monitoring equipment both on its trains and on its tracks. All these remedial measures are targeted for completion by September 2007. HK$73 million was incurred in 2006 for these improvements and repairs and the total estimated expenditure is expected to be approximately HK$217 million. While the total anticipated cost of implementing such improvements across the KCRC network is currently an estimation, there is no assurance that the actual costs to be incurred would be within such estimation.

On 14 February 2007, a potential transformer installed on top of a KCRC train carriage short-circuited and caused a small fire while the train was in the Tai Lam Tunnel heading towards Tsuen Wan. The function of the potential transformer was to check whether electricity was supplied to the train. After the potential transformer short-circuited, the electricity supply to the KCRC train was automatically cut off to ensure the safety of the passengers and the train. KCRC investigated the cause of the fault and a detailed report was submitted to the Hong Kong Railway Inspectorate at the end of April 2007.

The Company has had initial concerns over the asset life of certain East Rail trains.

The terms of the Rail Merger do not provide for warranties in relation to the condition or durability of the Concession Property. As a result, any costs which would need to be incurred to rectify problems with the Concession Property may be a direct cost to the Company. However, in relation to (i) the East Rail rolling stock underframe cracks and (ii) the East Rail rolling stock useful life (each as described above), KCRC has agreed to fund certain works (as described in the paragraph headed "Merger Framework Agreement" in the Appendix to this Circular headed "Transaction Agreements"). There can be no assurance that such funding will be sufficient to cover all of the costs required to be incurred in order to complete the relevant works satisfactorily and/or to rectify all relevant problems.

## RISKS RELATING TO THE STRUCTURE OF THE RAIL MERGER TRANSACTION

### *The Fare Adjustment Mechanism is not directly related to the costs of operating the Integrated Railway*

The Fare Adjustment Mechanism, which has been carefully considered by the Company and its financial advisers, requires the Company to adjust its fares according to a pre-determined formula based on changes in the composite consumer price index and wage index, and a productivity factor. Although the composite consumer price index and wage index correlate to the costs of the Company, the FAM is not directly linked to the costs of operating the Integrated Railway. There is a risk therefore that although the costs to the Company of operating the Integrated Railway may increase (for example, as a result of inflation or increased capital expenditure), the Company may not be able to raise its fares. Furthermore, because of the lack of a direct relationship between the Fare Adjustment Mechanism and the Company's cost base, there is also the risk that the Fare Adjustment Mechanism could require the Company to decrease its fares by a greater percentage than any decrease in the Company's costs.

As further discussed in the Letter from the Board (in the section of this Circular headed "Letter from the Board"), the Company believes that the FAM offers a predictable, objective and transparent solution to the question of fare adjustment as it is a direct-drive formula. It further provides that fares may increase in certain cases where the costs to the Company in operating the Integrated Railway have not risen to the same extent. It should be noted that, as further discussed in the paragraph headed "Buses and Public Light Buses" in the section of this Circular headed "Industry Background", similar risks are associated with some of the Company's road based competitors whose fares are subject to similar adjustment mechanisms based on a similar formula as the proposed Fare Adjustment Mechanism.

### *Breach of the MTR Ordinance or the Operating Agreement with respect to the Franchise relating to the KCRC System may potentially result in fines and/or, in an extreme case, revocation of the Franchise*

Since the partial privatisation of the Company in 2000, a breach of the MTR Ordinance and/or the Existing Operating Agreement could potentially result in the revocation of the Franchise. After the Rail Merger, the Company will be required to operate the KCRC System subject to the MTR Ordinance (as amended by the Rail Merger Ordinance) and the Operating Agreement. As a result, certain breaches thereof with respect to the KCRC System, could potentially result in a revocation of the entire Franchise (i.e. with respect to the MTRC Services as well as the KCRC services). The Company could however, pursuant to the MTR Ordinance, have the opportunity in certain circumstances, within specified time periods to remedy any such material breach prior to any revocation of the Franchise.

### *The Company is contracting with KCRC without any formal guarantee from the Government. After the Rail Merger, KCRC's only substantial asset will be its right to receive payments from the Company with respect to the Service Concession.*

The Rail Merger involves the Company entering into a number of arrangements with KCRC which is wholly-owned by the Government. The Government is not a party to all of the Transaction Agreements. The Government has not provided any guarantee in relation to the obligations of KCRC. However, in the Merger Framework Agreement the Government has provided that if, on or after the Merger Date, Government proposes to cease to be the majority shareholder of KCRC, Government and the Company shall, prior to Government so ceasing to be the majority shareholder of KCRC, agree arrangements designed to provide adequate comfort to the Company as to KCRC's performance of its obligations to the Company under the Transaction Agreements.

## RISKS OF POTENTIAL BENEFITS OF THE MERGER NOT TRANSPIRING

***Expected synergies not materialising***

The Company has estimated that it should be able to achieve synergies for the Integrated Railway of approximately HK$450m per annum once fully implemented. There is a risk that the expected synergies may not materialise. The Company is carrying out considerable measures to achieve these synergies and a number of internal teams have been established to enable the expected synergies to materialise after the Rail Merger.

***Operational interface issues not fully resolved before joint operations commence***

In order for the Rail Merger to be fully effected as planned there are a number of operational integration tasks which must be completed (although not necessarily with effect from the Merger Date). Such tasks include the integration of IT systems, station modifications and effective implementation of fare reductions. Delays in the completion of the integration may lead to delays in the achievement of the estimated synergies for the Company and could potentially affect the Company's reputation.

***Retention of employees***

The Company considers that the success of the Rail Merger is largely dependent on the dedication and commitment of both its and KCRC's staff. To that end, the Company, as well as complying with the Government's parameter relating to staff, is committed to ensuring that, to the extent possible, staff are not significantly disrupted as a result of the Rail Merger. Despite the efforts of the Company in relation to the staff integration process and reorganisation required to effect the Rail Merger, there remains a risk that the arrangements will not be acceptable to all staff and employees. If there were to be dissatisfaction amongst certain staff, it could cause them to leave the Company. This would naturally result in the loss of the skill, expertise and experience which they possess.

***Changes in political views, transport policies, regulator scrutiny and/or public and media attention***

As a result of the Rail Merger, the Company will grow considerably in terms of size and the revenue which it expects to generate. There is a risk that due to this growth there could be a change in political views towards the Company and it may face increased scrutiny from the Hong Kong transport regulators. There may also be heightened or increased public and/or media attention. However, the Company considers that by effecting the Rail Merger it is reiterating and enhancing its commitment to providing a first class transport network for Hong Kong and therefore the concerns of the transport regulators, the public and the media should be alleviated.

***The KCRC property business is subject to fluctuations in the Hong Kong property market as well as to general risks incidental to the ownership and management of properties. These fluctuations may affect the targeted profits of the Company***

The revenue generated from the Property Package is expected to account for a significant portion of the Company's net profit after the Rail Merger. Historically, the Hong Kong property market has been cyclical with property values affected by the amount of new land made available by the Government, the rate of economic growth in Hong Kong and political and economic developments in Hong Kong and the Mainland.

The acquisition of the economic benefits of the Property Package by the Company will increase the Company's land bank and as a result the Company will be further exposed to the general risks inherent in relation to property development, including that construction may not be completed on schedule or within budget, that development may be affected by Governmental regulations, that there may be delays in timing or a change of the parameters regarding Government land grants, that developed properties may not be leased or sold on profitable terms and that purchasers may default. The terms on which property developers are prepared to bid for development packages may also be affected by the state of the property market.

In the event that there is a down-turn in the property market in Hong Kong the targeted revenue from the Property Package could be significantly reduced.

LegCo approved the Rail Merger Ordinance on 8 June 2007. The Rail Merger Ordinance will come into operation on the Merger Date.

The Rail Merger Ordinance, amongst other things, amends the KCRC Ordinance and the MTR Ordinance to provide the necessary legislative framework for the Rail Merger and for the operation by the Company of the MTRC Railway, the KCRC Railway and certain other railways under one franchise, and to enable the KCRC to enter into a Service Concession Agreement with the Company.

The Rail Merger Ordinance is divided into 4 Parts. Part 1 (sections 1 and 2) provides for the short title and commencement. Part 2 (sections 3 to 25) amends the MTR Ordinance. Part 3 (sections 26 to 35) amends the KCRC Ordinance. Part 4 (section 36) provides for consequential and related amendments.

***Section 3*** amends the long title of the MTR Ordinance to reflect changes in the scope of the MTR Ordinance regarding the expansion of the Franchise granted to the Company and the regulation of the operation of certain railways in addition to the regulation of the operation of the MTRC Railway.

***Section 4*** amends the Chinese short title of the MTR Ordinance.

***Section 5*** amends certain existing definitions in the MTR Ordinance and adds new definitions.

***Section 6*** amends section 4 of the MTR Ordinance to provide that the Franchise granted to the Company under the MTR Ordinance covers the construction and operation of railways other than the MTRC Railway and, subject to any extension, lasts 50 years from the Merger Date.

***Section 7*** amends section 5 of the MTR Ordinance to provide that the operation by the Company of the TSA Buses is a relevant consideration in any recommendation made by the Secretary as to whether the Franchise should be extended.

***Section 8*** amends section 9 of the MTR Ordinance to impose an obligation on the Company to ensure that where the Company operates the TSA Buses during the Concession Period, it must ensure that the TSA Buses are operated properly and efficiently under the MTR Ordinance, all other applicable laws and the Operating Agreement.

***Section 9*** adds a new section to impose an obligation on the Company to construct and maintain certain facilities for the use of occupiers of private land adjoining any railway operated by the Company under the Service Concession Agreement.

***Section 10*** amends section 13 of the MTR Ordinance to enable the Chief Executive in Council to give directions to the Company in respect of the TSA Buses operated by the Company.

***Section 11*** adds new provisions to Part IV of the MTR Ordinance to provide for:

(a) compensation which may be payable by the Government to the Company in relation to the KCRC Railway where any part of the Franchise relating to the KCRC Railway is suspended;

(b) requirements under which:

    (i) when the Franchise is suspended (whether in whole or in part), the Government may have access to and use certain property which remains in the possession of the Company;

    (ii) when any part of the Franchise is suspended, the Company may have access to and use certain property taken possession of by the Government in connection with the suspension.

***Section 12*** amends section 16 of the MTR Ordinance to provide that certain types of breaches of the Service Concession Agreement may amount to a default under the franchise and a major breach of the Service Concession Agreement is a default under the franchise.

***Section 13*** amends section 17 of the MTR Ordinance to provide that a major breach of the Service Concession Agreement is not to be regarded as a default capable of being remedied for the purposes of section 17(1) of the MTR Ordinance.

***Section 14*** amends section 18 of the MTR Ordinance to provide for the circumstances under which the Chief Executive in Council may revoke that part of the franchise relating to the KCRC Railway.

***Section 15*** adds new provisions to Part IV of the MTR Ordinance to provide for:

(a) taking possession of Concession Property by the Government when the Franchise or that part of it relating to the KCRC Railway is revoked or when the franchise expires;

(b) compensation which may be payable by the Government to the Company in relation to Concession Property where Concession Property is taken possession of in circumstances referred to in paragraph (a); and

(c) requirements under which:

    (i) when the Franchise or that part of it relating to the KCRC Railway is revoked or when it expires, the Government may have access to and use certain property which remains in the possession of the Company;

    (ii) when that part of the Franchise relating to the KCRC Railway is revoked and that part of it relating to the MTRC Railway remains in force, the Company may have access to and use certain property taken possession of by the Government in connection with such revocation.

***Section 16*** amends section 33 of the MTR Ordinance. A provision of section 33 of the MTR Ordinance, which allows the Secretary to make regulations for the purpose of controlling and regulating the use of the railway by members of the public and their conduct while on railway premises, is repealed. In addition, new provisions are added to section 33 to enable the Secretary to make regulations in respect of the expanded scope of the Franchise during the Concession Period. The Secretary has made regulations pursuant to this power. These regulations will become effective on the Merger Date.

***Section 17*** adds new provisions to section 34 of the MTR Ordinance to enable the Company to make by-laws in respect of the expanded scope of the Franchise during the Concession Period. The Company has made by-laws pursuant to this power. These by-laws will become effective on the Merger Date.

***Section 18*** adds new provisions to section 35 of the MTR Ordinance to facilitate the adducing of evidence in any proceedings for an offence against any bylaw relating to the control of access to restricted areas in railway premises.

***Section 19*** amends section 36 of the MTR Ordinance by adding an extended definition of "Corporation" for the purposes of part IX of the MTR Ordinance.

***Section 20*** adds a new Part to the MTR Ordinance which provides for a mechanism through which certain rights and liabilities of KCRC are to be vested in the Company in connection with the Rail Merger, and matters related to the vesting of rights and liabilities through the mechanism, and provides for the vesting in the Company of the rights and liabilities under employment contracts entered into with KCRC and under pension schemes established for KCRC employees.

***Section 21*** amends section 53 of the MTR Ordinance to provide that a decision of the Secretary relating to having access to property remaining in the possession of the Company under section 15B or 19C of the MTR Ordinance or to taking possession of Concession Property under section 19A of the MTR Ordinance, in addition to certain other decisions made under other specified provisions, is not subject to appeal under section 53 of the MTR Ordinance.

***Section 22*** adds new provisions to the MTR Ordinance so that during the Concession Period: (a) the disapplication of certain provisions of the Public Health and Municipal Services Ordinance (Cap. 132 of the Laws of Hong Kong) under section 54(1) of the MTR Ordinance will not apply in relation to any part of the Franchise relating to the KCRC Railway; (b) section 11 of the Tramway Ordinance (Cap. 107 of the Laws of Hong Kong) will apply to Light Rail; and (c) certain provisions of the Public Bus Services Ordinance (Cap. 230 of the Laws of Hong Kong) will apply to the TSA Buses operated by the Company.

***Section 23*** amends section 59 of the MTR Ordinance by adding a definition of "Corporation" which is necessitated by the change of the Company's Chinese name to "香港鐵路有限公司" on the Merger Date.

***Section 24*** amends section 61 of the MTR Ordinance to provide that, in addition to the Secretary, the Commissioner or any other person who pursuant to a provision in the MTR Ordinance is required to consult with the Company in relation to any matter, is not obliged to obtain the agreement of the Company in relation to the matter.

***Section 25*** adds a new section to the MTR Ordinance to provide that on the Merger Date, the Chinese name of the Company is changed from "地鐵有限公司" to "香港鐵路有限公司" and that the Registrar of Companies shall enter the Company's new Chinese name into the register and issue to the Company a certificate of change of name.

***Section 26*** amends the long title of the KCRC Ordinance to reflect changes in the scope of that Ordinance in connection with the Service Concession Agreement.

***Section 27*** amends certain existing definitions in the KCRC Ordinance, adds certain new definitions, and makes amendments to provide that the Chief Executive in Council may, during the Concession Period, upon being satisfied that the Company and KCRC have been consulted about the variation, require the Commissioner to vary the boundaries of the North-west Transit Service Area within the meaning of the KCRC Ordinance.

***Section 28*** amends section 3 of the KCRC Ordinance to provide that during the Concession Period, the office of the Chief Executive Officer of KCRC may be left vacant and that where the office is left vacant, the managing board of KCRC shall not include a Chief Executive Officer.

***Section 29*** amends section 4 of the KCRC Ordinance to enable KCRC to grant the right to have access to, use or possess its railways and certain other property for the operation of those railways and the TSA Buses to the Company, and to dispose of certain property under or in connection with such grant. Moreover, provisions are added to stipulate that, subject to certain exceptions specified in the KCRC Ordinance, KCRC shall not exercise its existing powers to operate and construct railways during the Concession Period.

***Section 30*** adds new provisions to section 30 of the KCRC Ordinance to enable the Secretary to suspend regulations made by him under the KCRC Ordinance during the Concession Period. Pursuant to this power the Secretary has suspended such regulations. The suspension will become effective on the Merger Date.

***Section 31*** adds new provisions to section 31 of the KCRC Ordinance to enable KCRC to suspend by-laws made by it under the KCRC Ordinance during the Concession Period. Pursuant to this power KCRC has suspended such by-laws. The suspension will become effective on the Merger Date.

***Section 32*** adds a new Part to the KCRC Ordinance to provide for the suspension of certain provisions in the KCRC Ordinance during the Concession Period.

***Section 33*** amends paragraph 9 of the First Schedule of the KCRC Ordinance to stipulate the quorum of the members of KCRC during the Concession Period.

***Section 34*** amends paragraphs 3 and 4 of the Second Schedule of the KCRC Ordinance by deleting reference to KCRC operating the railway on the land specified in these paragraphs.

***Section 35*** amends paragraphs 2(b) and 3(a) of the Fifth Schedule of the KCRC Ordinance by deleting reference to KCRC (a) operating Light Rail in paragraph 2(b), and (b) constructing and maintaining the platforms on Light Rail in paragraph 3(a).

***Section 36*** provides for consequential and related amendments necessitated by the enactment of the Rail Merger Ordinance. They include amendments to other ordinances and subsidiary legislation.

Set out below is a description of each of the principal Transaction Agreements. Copies of each are available for inspection at during normal working hours at the Company's offices at MTR Tower, Telford Plaza, Kowloon Bay, Kowloon, Hong Kong, up to and including the date of the Merger EGM.

## A) THE MERGER FRAMEWORK AGREEMENT

The Merger Framework was entered into on the Signing Date between the Company, KCRC and the Secretary and the Secretary for Financial Services and the Treasury for and on behalf of the Government.

The Merger Framework Agreement contains the detailed provisions for the overall structure of the Rail Merger and provides for certain rights and obligations of the Company, KCRC and the Government after the completion of the Rail Merger including, amongst other things, corporate governance, the seamless interchange programme, certain property and employment related matters and certain adjustments to the fares of the Integrated Railway from and following the Merger Date. The Merger Framework Agreement covers the matters set out below.

***Conditions***

The Merger Framework Agreement provides that the Transaction Agreements are conditional upon:

(1) the Independent Shareholders passing the EGM Resolution to approve the Rail Merger and the Transaction Agreements at the Merger EGM;

(2) each of the other Transaction Agreements (other than certain Transaction Agreements which will be entered into after the Merger Date) becoming effective on the Merger Date.

***Merger Date***

If the Merger Date does not occur on or before 1 June 2008 the Company and the Government each have the right to terminate the Merger Framework Agreement.

Each of the Company and KCRC has acknowledged that the Secretary has an absolute and unfettered discretion as to the appointment of the Merger Date and has agreed that neither of them has any recourse whatsoever against the Secretary or the Government in respect of the timing of appointment of the Merger Date or any decision not to appoint a Merger Date.

***Framework for the Rail Merger***

The Merger Framework Agreement provides that the Rail Merger shall include:

- pursuant to the SPA, the sale and purchase of the Purchased Rail Assets and the KCRC Subsidiaries;
- pursuant to the Property Package Agreements and the SPA, arrangements for the transfer to the Company of the economic benefits of the Property Package;
- pursuant to the Rail Merger Ordinance, the expansion of the Company's franchise under the MTR Ordinance to enable the Company to operate the Integrated Railway under a single franchise;
- pursuant to the Operating Agreement, the operation by the Company of the Integrated Railway as an integrated system;

- pursuant to the Service Concession Agreement, an arrangement under which, amongst other things, KCRC shall grant the Service Concession to the Company in order to enable the Company to access and use the Concession Property to provide the KCRC Services, and the Company shall provide the KCRC Services to the Required Standards;

- pursuant to the KSL Project Management Agreement, an arrangement under which the Company will act as KCRC's agent in connection with the KSL under certain circumstances;

- pursuant to the West Rail Agency Agreement, an arrangement under which the Company will act as agent of KCRC and each West Rail Subsidiary in connection with the development of properties at, adjacent to or above WR;

- pursuant to the US CBL Assumption Agreements, arrangements under which the Company will become a co-obligor, together with KCRC, of certain of KCRC's obligations to the counterparties of the CBLs;

- pursuant to the US CBL Allocation Agreement, arrangements delineating the rights and obligations between KCRC and the Company in respect of the exercise of rights and the performance of obligations under the terms of the CBLs.

The parties acknowledge that the Rail Merger and the Transaction Agreements comprise an integrated package of terms.

***Seamless Interchange Programme***

The Company has undertaken that it shall complete a specified programme of milestone dates and preparatory work relating to station modification and the provision of barrier free interchanges at Nam Cheong, Mei Foo and Kowloon Tong stations, the integration of operations at those stations and at Tsim Sha Tsui station, the integration of the ticketing systems for Octopus users and single journey ticket users and the establishment of an integrated communication coordination centre and hotline system. The external costs and expenses of implementing the seamless interchange programme up to the Merger Date shall be borne equally by the Company and KCRC and each of them shall bear its own internal costs and expenses. All costs and expenses of the seamless interchange programme incurred on or after the Merger Date shall be borne by the Company.

***Corporate Governance***

With effect from the Merger Date, the Company shall procure that the majority of its Directors shall be independent non-executive directors. In addition, the Company's nomination committee, which shall have the function of nominating candidates to fill vacancies on the Board, shall be composed of seven non-executive Directors (including the Chairman of the Company and two non-executive Directors representing the Government) with the majority being independent non-executive Directors, and shall be chaired by an independent non-executive Director. Government may also, at its sole discretion, determine before the Merger Date the number of additional non-executive Directors (if any) to be appointed to the Board on the Merger Date.

***Payments Relating to Property Enabling Works***

For each of the Property Enabling Works Development Sites, KCRC shall be responsible for the funding of the property enabling works. Such funding shall be recovered from the Company for the relevant development site in an amount set out in a schedule to the Merger Framework Agreement. The Company, in turn, shall seek to recover such amount from the developer of that development site. If, for a relevant development site, the actual amount received from the relevant developer is less than the relevant amount set out in the schedule, the Company shall be responsible for the shortfall. If the actual amount received from the relevant developer for a relevant development site is more than the amount set out in the schedule, the Company shall be entitled to the excess.

***Land Policy Related Matters***

The Company and the Government have acknowledged that a mechanism is needed which enables the Government to exercise control in exceptional circumstances on the level of flat production (being the number of flats which the Company puts out to tender to developers) arising from tender programmes for railway property development which is consistent with the way the Government monitors the overall housing supply situation. The Government and the Company shall conduct an annual exercise to discuss and draw up a three-year rolling programme on the level of flat production arising from tenders for railway property development by the Company for the three succeeding years (on a financial year basis). The level of flat production (rounded to the nearest 100) arising from tenders for railway property development in each of these three years shall be reviewed, before the Government's Application List for Land Sale is finalised and announced in February/March each year. The first year of the three-year rolling programme shall be binding on the Company. The agreed level of flat production arising from tenders for railway property development may be revised as and when necessary, if this is mutually agreed by the Government and the Company. The annual exercise shall be initiated by the Government in the last quarter of each calendar year, for conclusion before the end of that year. For the avoidance of doubt, the first such annual exercise shall be initiated by the Government on or around the September that first occurs after the Merger Date.

***Other Property Related Matters***

The Operating Agreement, in so far as it relates to land for New Projects, property development rights, land premium amounts and consultation on New Projects, shall continue to apply. The Government also agrees that the land premium amounts payable by the Company will be assessed on a "full market value" basis ignoring the presence of the railway for property development rights in relation to the Category 4 Properties other than the property known as "Tin Shui Wai Terminus, Light Rail, Yuen Long, New Territories".

***Employee Related Matters***

On the Merger Date, the Company shall sign, seal and deliver a deed poll in favour of Relevant Frontline Staff. The deed poll provides that the Company shall not terminate the employment contract of any Relevant Frontline Staff member for any reason that relates to the process of integrating the operations of the Company and KCRC pursuant to the Rail Merger.

***Fare Reductions***

The Company shall, in respect of the Integrated Railway (with the exception of the Airport Express, Light Rail, cross-boundary trips to/from Lo Wu/Lok Ma Chau and intercity trains):

(i) remove the second boarding charge of HK$1-7 for adults, and remove the corresponding second boarding charge in respect of Concession Fares and Student Fares;

(ii) reduce all adult Octopus fares by HK$0.20;

(iii) reduce the adult fares for all journeys with fares at or above HK$12 by an additional HK$1;

(iv) for each adult journey of HK$12 or above, if (i) to (iii) above when combined result in less than a 10% fare reduction for that journey, procure that there shall be a further reduction to achieve a minimum of a 10% fare reduction for that journey;

(v) for each adult journey of between HK$8.50 and HK$11.90 (inclusive), if (i) and (ii) above when combined result in less than a 5% fare reduction for that journey, procure that there shall be a further reduction to achieve a minimum of a 5% fare reduction for that journey;

(vi) procure that the dollar amount of reductions for Concession Fares shall be half of the adult fare reductions; and

(vii) procure that the dollar amount of reductions for Student Fares shall be half of the adult fare reductions for journeys taken wholly within the MTRC Railway, the dollar amount of reductions for Student Fares shall be the same as for the adult fare reductions for journeys taken wholly within the KCRC Railway and the percentage fare reductions for Student Fares shall be the same as the corresponding adult fare reductions for journeys involving an interchange between the MTRC Railway and the KCRC Railway.

***Application of Fare Reductions***

The timing of the implementation of the above fare reductions shall be as follows:

- The fare reductions shall all apply to Octopus users on and from the Merger Date.

- The fare reductions referred to in (i) shall apply to single journey ticket users on and from a date falling within one year from the Merger Date.

- For the period from (and including) the Merger Date to (but excluding) the date on which the integrated ticketing system for single journey ticket users (as referred to in the section headed "Seamless Interchange Programme" above) is implemented, the fare reductions referred to in (iii), (iv) and (v) above (and (vi) and (vii) to the extent they relate to (iii), (iv) and (v)) shall apply only to single journey ticket users travelling within a single system provided that each fare reduction resulting from the application of (iv) and (v) (and (vi) and (vii) above to the extent they relate to (iv) and (v)) shall be rounded up or down (as the case may be) to the nearest interval of HK$0.50.

- From (and including) the date on which the integrated ticketing system for single journey ticket users (as referred to in the section headed "Seamless Interchange Programme" above) is implemented, the fare reductions set out in clauses (iii), (iv) and (v) above (and (vi) and (vii) to the extent they relate to (iii), (iv) and (v)) shall apply to all single journey ticket users provided that each fare reduction resulting from the application of (iv) and (v) (and (vi) and (vii) above to the extent they relate to (iv) and (v)) shall be rounded up or down (as the case may be) to the nearest interval of HK$0.50.

For one year commencing on the Merger Date, the Company shall provide an Octopus concessionary fare of HK$2 for all journeys on the Integrated Railway made by the elderly (being persons aged 65 or above) on Sundays and public holidays.

The Company shall maintain the status quo as at the date of the Memorandum of Understanding (being 11 April 2006) with respect to Student Fares discounts by continuing to provide a 50% discount on Student Fares for the MTRC Railway and no discount on Student Fares for the KCRC Railway, subject to the Fare Adjustment Mechanism applying to the Student Fares from and including the Merger Date.

The Company has agreed that it will not increase fares to which the Fare Adjustment Mechanism (the terms of which are provided in the Operating Agreement) applies until after 30 June 2009. For the period ending on the Merger Date, KCRC shall not increase fares for the KCRC Railway.

***Shatin to Central Link***

The proposed SCL project consists of an extension of the existing MOSR from Tai Wai to Hung Hom and an extension of the existing East Rail from Hung Hom to Central. If, in its absolute discretion, the Government decides to implement the SCL, the SCL shall be treated in the same way as a New Separate Project in accordance with the Operating Agreement, as further described below under the paragraph headed "New Railway Projects" in the section headed "Operating Agreement", except that the invitations referred to therein shall be to the Company only. The Kwun Tong Line extension shall be treated as a New MTR Project in accordance with the Operating Agreement, as further described below under the paragraph headed "New Railway Projects" in the section headed "Operating Agreement".

***Light Rail, East Rail and West Rail Related Concession Schemes.***

The Company shall retain the following concession schemes which are offered by KCRC as at the Signing Date:

- "Light Rail Personalised Octopus Frequent User Bonus Scheme";
- Free transfers on Light Rail and TSA Buses (on journeys with an adult Octopus fare of HK$3.9 or less, or a Concession Fare of HK$1.9 or less) for West Rail passengers using Octopus (except TSA Bus routes A73 and K73P);
- Free transfers on TSA Buses for Light Rail passengers using Octopus (except TSA Bus routes A73 and K73P);
- "West Rail Octopus One-month Pass" at $300 and $400; and
- "West Rail Discovery Pass" at $20,

in each case up to 30 June 2009, and any modification to these schemes thereafter shall be subject to the relevant provisions of the Operating Agreement.

***Maintaining certain Light Rail Routes and TSA Bus Routes***

The Company shall maintain (i) the TSA Bus route K73P (which operates between Tin Heng and Yuen Long East); and (ii) special trips of Light Rail route 761P (which operates between Tin Wing and Yuen Long Terminus), in each case at a level not lower than that offered by KCRC as at 6 June 2007. Such commitment expires on 31 December 2008, and any modification to these services thereafter shall be subject to the relevant provisions of the Operating Agreement.

***East Rail Rolling Stock Underframe Cracks***

On receipt of any written demand by the Company on or after the Merger Date, KCRC shall as soon as practicable fund any payments required to be made in respect of the rectification work for the East Rail rolling stock underframe cracks, up to an aggregate amount of (i) HK$217.3 million (less the aggregate amount spent by KCRC prior to the Merger Date on or in relation to such works as certified by KCRC) and (ii) an amount in respect of reasonable claims by contractors in respect of such works.

***East Rail Rolling Stock Asset Life***

On receipt of any written demand by the Company on or after the Merger Date, KCRC shall as soon as practicable fund any payments required to be made in respect of the work to secure the asset life of the East Rail rolling stock up to an aggregate amount of (i) HK$250 million (less the aggregate amount spent by KCRC prior to the Merger Date on or in relation to such works as certified by KCRC) and (ii) an amount in respect of reasonable claims by contractors in respect of such works.

***Platform gap filler works***

On receipt of any written demand by the Company on or after the Merger Date, KCRC shall, as soon as practicable, fund any payments required to be made in respect of platform gap filler works, up to an aggregate amount of (i) HK$102 million and (ii) an amount in respect of reasonable claims by contractors in respect of such works.

***Other Undertakings of the Company***

*Toilet facilities.* The Company has agreed and undertaken that it shall include in its design parameters, prepared in respect of any new railway line to be constructed and operated by the Company on or after the Merger Date, the provision of toilet facilities within, or adjacent to, stations which form part of such new railway line.

*Provision of low-floor buses for TSA Buses fleet.* The Company has agreed and undertaken that it shall, prior to 31 December 2015, replace the whole fleet of TSA Buses with low-floor buses and discuss with organisations of disabled citizens to examine measures to facilitate the use of low-floor buses by disabled persons with a view to introducing such measures into the operation of the TSA Buses, and in due course report to LegCo its progress and findings in relation to these matters.

*Improvement of station facilities.* The Company has agreed and undertaken that, within 2 years following the Merger Date, it shall provide at least one wide-gate entry in each station of the KCRC Railway and the MTRC Railway to improve the accessibility of the KCRC Railway for people with disabilities and to ensure the continued accessibility of the MTRC Railway for people with disabilities.

***KCRC's Debt and Other Financing Obligations***

Subject to provisions relating to the CBLs, KCRC shall be responsible for its obligations under the KCRC Financing Documents; and KCRC shall remain party to the KCRC Financing Documents and shall comply therewith. None of the KCRC Financing Documents shall be vested into or be novated to the Company.

***KCRC's Cross Border Leases***

The arrangements regarding the CBLs shall be governed by the Merger Framework Agreement, the US CBL Assumption Agreements and the US CBL Allocation Agreement.

KCRC warrants that all steps required under the terms of the CBLs to allow the Rail Merger to take effect in accordance with the terms of the CBLs have been taken or will be taken prior to the Merger Date; and that as at the Merger Date, no breaches of, or events of default under, the CBLs have arisen or will arise as a result of the Rail Merger taking effect.

KCRC and Government have agreed to indemnify the Company for losses (and for reasonable costs incurred) arising from the due and proper performance by the Company of the MTRC Obligations (which term is described below in the section headed "KCRC Cross Border Lease Agreements"), and KCRC has agreed to indemnify the Company for losses (and for reasonable costs incurred) arising from KCRC not complying with its obligations under the CBLs other than the MTRC Obligations. The indemnities are in each case subject to certain exclusions (which exclusions include costs or expenses which the Company would have incurred in any event in respect of the relevant Concession Property (regardless of whether or not such property were subject to the terms of the CBLs) and losses which arise from the Company's own fraud, negligence or bad faith and/or the failure of the Company to perform certain covenants).

The Company has agreed to indemnify each of Government and KCRC for losses (and for reasonable costs incurred) arising from any breach of the Company's representations, covenants and agreements provided for in the Merger Framework Agreement in relation to the CBLs, including in respect of MTRC not complying with the MTRC Obligations under the CBLs. The indemnity is subject to certain exclusions (which exclusions include Government's or KCRC's own fraud, negligence or bad faith and/or the failure of Government or KCRC to perform certain covenants).

***Third Party Claims***

On and from the Merger Date, KCRC shall continue to be responsible for all KCRC Claims and, unless KCRC and the Company agree otherwise, all Railway Project Claims. The Company shall be responsible for all MTRC Claims.

***Name of the Company***

On the Merger Date, the Company shall retain its English name but, pursuant to the Rail Merger Ordinance, its Chinese name shall be changed to "香港鐵路有限公司".

***Government Support***

If, on or after the Merger Date, the Government proposes to cease to be the majority shareholder of KCRC, the Government and the Company shall, prior to the Government so ceasing to be the majority shareholder of KCRC, agree arrangements designed to provide adequate comfort to the Company as to KCRC's performance of its obligations to the Company under the Transaction Agreements.

***Representations and Warranties***

Subject to certain conditions set out in the MFA, KCRC provides warranties in relation to, amongst other things, its status as a statutory corporation, its power and authority to enter into, deliver and comply with its obligations under, and the effectiveness of its obligations under, the Transaction Agreements, its legal authority to carry out its business, that the transactions contemplated by the Transaction Agreements will not contravene any law to which it is subject or its constitutive documents, and that it is not insolvent or bankrupt under the laws of Hong Kong.

The Company provides warranties in relation to, amongst other things, its due incorporation and valid existence with limited liability under the laws of Hong Kong, its power and authority to enter into, deliver and comply with its obligations under, and the effectiveness of its obligations under, the Transaction Agreements, its legal authority to carry out its business, that the transactions contemplated by the Transaction Agreements will not contravene any law to which it is subject or its constitutive documents, and that it is not insolvent or bankrupt under the laws of Hong Kong.

The Government provides warranties in relation to, amongst other things, its power and authority to enter into, deliver and comply with its obligations under, and the effectiveness of its obligations under, the Transaction Agreements and that the Transaction Agreements will not contravene any law to which it is subject or, to the best of its knowledge and belief, breach any agreement or the terms of any authorisation which is binding on it. To the extent that the Government or any of its properties, assets or revenues may have or may hereafter become entitled to any right of immunity in any Hong Kong court or arbitration in which proceedings may at any time be commenced in relation to the Transaction Agreements, the Government waives or will waive such right to the extent permitted by law and has consented to the giving of relief and the enforcement of any order or judgment in relation to the Transaction Agreements.

***Dispute Resolution Procedure***

The process for settling disputes between the parties must begin with informal negotiation (except where the dispute relates to a payment obligation). If the dispute is not resolved through informal negotiation or where informal negotiation is not required, the courts of Hong Kong shall have exclusive jurisdiction to settle the dispute. The dispute may be referred to mediation or arbitration if the relevant parties agree.

***MTR Ordinance and Rail Merger Ordinance***

Nothing in any Transaction Agreement shall oblige a party to that Transaction Agreement to conduct its business in any manner or to do anything which is incompatible with or in breach of any provision of the MTR Ordinance or the Rail Merger Ordinance.

***Law***

Each Transaction Agreement (and any dispute, controversy, proceedings or claims of whatever nature arising out of or in any way relating to that Transaction Agreement) shall be governed by and construed in all respects in accordance with Hong Kong law.

## B) SERVICE CONCESSION AGREEMENT

The Service Concession Agreement was entered into on the Signing Date between the Company and KCRC.

The Service Concession Agreement contains the detailed provisions of the Service Concession granted by KCRC to the Company in relation to the KCRC Railway. The Service Concession Agreement covers the matters set out below.

### Effective Date

The Service Concession Agreement is conditional upon each of the other Transaction Agreements (other than certain Transaction Agreements which will be entered into after the Merger Date) becoming effective on the Merger Date. The Service Concession Agreement is a "Service Concession Agreement" for the purposes of section 2(1) of the MTR Ordinance and section 2(1) of the KCRC Ordinance.

### Grant of Service Concession and Grant of Licence

***Service Concession and licence to use the KCRC Railway Land***

The Service Concession Agreement provides the grant by KCRC to the Company (on an exclusive basis) of a service concession to access, use and operate the Concession Property. For the avoidance of doubt, the only right conferred on the Company in respect of the KCRC Railway Land is a licence to use it for the purposes of carrying out the KCRC Services. The Company acknowledges that its rights to access and use the KCRC Railway Land (which at any time forms part of the Concession Property) during the Concession Period are:

- limited to those rights that are necessary for the Company to provide the KCRC Services to the Required Standards applicable to the KCRC Services;

- subject to all and any reservations, restrictions, exceptions, covenants, conditions, provisos, easements and other appurtenant rights applicable to or affecting the KCRC Railway Land (or any part thereof) and in existence immediately prior to the Merger Date or (in the case of any such KCRC Railway Land which forms part of any property designated in the relevant Supplemental Service Concession Agreement to be New Project Concession Property with respect to such New Project for the purposes of the Service Concession Agreement ("**New Project Concession Property**") in existence immediately prior to the relevant effective date of that New Project ("**New Project Effective Date**"));

- subject to all and any reservations, restrictions, exceptions, covenants, conditions, provisos, easements and other appurtenant rights applicable to or affecting the KCRC Railway Land (or any part thereof) and arising on or after the Merger Date pursuant to the provisions of the Land Comfort Letter and/or pursuant to any change in law or regulation having the force of law; and

- subject to the consent of the Director of Lands under the KCRC Ordinance and all relevant vesting deeds or land grants governing the KCRC Railway Land and the compliance by KCRC and the Company with the terms and conditions that the Director of Lands may impose in granting such consent.

***New Projects***

The Service Concession Agreement provides that any new railway project that is constructed by, leased to or vested in KCRC (other than any railway project that is already part of the Service Concession) and that is, pursuant to the terms of the Operating Agreement, to be the subject of a service concession on the terms contained in the Service Concession Agreement and the relevant Supplemental Service Concession Agreement, shall be subject to a service concession granted by KCRC in favour of the Company and the parties shall enter into a Supplemental Service Concession Agreement in respect of such new railway project.

***KCRC covenants in respect of the Concession Property***

During the Concession Period, KCRC shall not grant to any other party, nor shall KCRC itself exercise (i) in respect of any Concession Property, any rights which are the same as or similar to any of the rights granted to the Company pursuant to the Service Concession Agreement; and (ii) in respect of any New Project Concession Property, any rights which are the same as or similar to any of the rights granted to the Company pursuant to the Service Concession Agreement and the relevant Supplemental Service Concession Agreement.

Further, KCRC shall not carry out any act, or permit any act to be carried out, in relation to any Concession Property which in any way affects, prejudices or interferes with the rights of the Company under the Service Concession Agreement or the provision of the KCRC Services by the Company, except:

- pursuant to any exercise by KCRC of any of its rights set out in the Transaction Documents;

- if KCRC is required to do so in order to comply with any relevant law or regulation having the force of law which is binding on KCRC (including the KCRC Ordinance and the Rail Merger Ordinance); or

- pursuant to any reservation, restriction, exception, covenant, condition, proviso, easement or other appurtenant right applicable to or affecting the KCRC Railway Land.

**Concession Period**

The Concession Period shall commence in the case of any Concession Property other than any New Project Concession Property, on the Merger Date; in the case of any New Project Concession Property, on the relevant New Project Effective Date; and in the case of any Additional Concession Property, on the date on which such Additional Concession Property becomes Additional Concession Property.

The Concession Period shall terminate automatically on the earliest of (i) the revocation of the Franchise pursuant to the MTR Ordinance as it relates to the KCRC Railway; and (ii) the Natural Expiry Date or, where the term of the Service Concession has been extended, the new expiry date (as provided in the paragraph below).

If, at any time or times during the Concession Period, the term of the Franchise (as it relates to the KCRC Railway) is extended, the Concession Period shall be automatically extended, from the date on which the term of the Franchise (as it relates to the KCRC Railway) is so extended, for an identical period.

**The KCRC Services**

At all times during the Concession Period, the Company shall, provide the KCRC Services to the Required Standards applicable to the KCRC Services.

**Payments and Deposits**

The Company shall pay to KCRC the following Concession Payments:

- ***Upfront Payment*** on the Merger Date of an amount totalling HK$4.25 billion, being the agreed fee for the right to operate the Service Concession and the consideration for the Purchased Rail Assets.

- ***Fixed Annual Payments*** on the day immediately preceding each anniversary of the Merger Date which falls during the Concession Period, in arrears, a fixed amount of HK$750 million for the right to use and operate the Concession Property for the operation of the Service Concession in respect of the 12 month period up to and including the date on which such payment falls due. There shall be no increase in the Fixed Annual Payments as a result of the commencement of operations of KSL or LMCSL.

- ***Variable Annual Payments*** in respect of each financial year of the Company which ends during the Concession Period for the right to use and operate the Concession Property for the operation of the Service Concession. The Variable Annual Payment payable by the Company for each financial year shall be calculated on a tiered basis by reference to the amount of the KCRC System Revenue for that financial year, in accordance with the following table:

| KCRC System Revenue for a financial year of the Company (determined using the revenue allocation system set out in the SCA) | % of KCRC System Revenue as part of Variable Annual Payment for that financial year |
|---|---|
| First HK$2.5 billion of KCRC System Revenue (i.e. HK$0.0 - HK$2.5 billion) | 0.0% |
| Next HK$2.5 billion of KCRC System Revenue (i.e. > HK$2.5 billion and ≤ HK$5.0 billion) | 10.0% |
| Next HK$2.5 billion of KCRC System Revenue (i.e. > HK$5.0 billion and a ≤ HK$7.5 billion) | 15.0% |
| KCRC System Revenue beyond the first HK$7.5 billion (i.e. > HK$7.5 billion) | 35.0% |

The Service Concession Agreement provides the mechanism pursuant to which the Variable Annual Payments are to be made. The Variable Annual Payments will be payable annually in arrears within 60 days after the end of the relevant financial year of the Company (and will be adjusted if, following finalisation of the Company's audited accounts, the amount paid by the Company within the 60 day period referred to above is not correct). No Variable Annual Payment shall be payable in respect of any KCRC System Revenue generated during the period from (and including) the Merger Date to (but excluding) the day which falls on the third anniversary of the Merger Date.

If the Concession Period is extended, the Fixed Annual Payments and the Variable Annual Payments shall continue to be payable by the Company. The Service Concession Agreement provides the mechanism to calculate the Fixed Annual Payment if expiry or termination of the Service Concession does not fall on the day immediately preceding an anniversary of the Merger Date. The Service Concession Agreement also provides the mechanism to calculate the Variable Annual Payment if expiry or termination of the Service Concession does not fall on the last day of a financial year of the Company. The Company's obligations to make any payments under the Service Concession Agreement are absolute and unconditional and no amount payable under the Service Concession Agreement shall cease to be payable or shall be suspended or reduced by reason of any contingency. The Company and KCRC have agreed that the KCRC Railway Land has no meaningful value, given its legal characteristics, use and enjoyment, and accordingly that no part of the Concession Payments relates to the KCRC Railway Land.

In respect of any New Project Concession Property, the Company shall pay KCRC the Concession Payments as set out in, or otherwise determined in accordance with, and at the times provided in, the relevant Supplemental Service Concession Agreement.

On the Merger Date, KCRC shall transfer to the Company all amounts held by KCRC immediately prior to the Merger Date as deposits in respect of the use by third parties of Concession Property and amounts constituting retention monies or advances in relation to Concession Property less an appropriate amount to be retained by KCRC to reflect unpaid amounts due to KCRC prior to the Merger Date against which such deposits, retention monies or advances are held. During the Concession Period, the Company shall refund any deposits due to any third parties in accordance with the terms on which such deposits are held by KCRC immediately prior to the Merger Date.

**Concession Property**

***General***

During the Concession Period, subject to certain restrictions in respect of KCRC Railway Land, the Company shall, at all times, have the exclusive right to access, use and operate the Concession Property as at the Merger Date (the "**Initial Concession Property**"). KCRC shall grant to the Company the exclusive right to access, use and operate each item of New Project Concession Property on and from the relevant New Project Effective Date and as legal and beneficial owner of Additional Concession Property, the Company shall have the exclusive right to access, use and operate each item of such Additional Concession Property on and from the date on which such Additional Concession Property becomes Additional Concession Property.

In respect of KCRC Railway Land which comprises Initial Concession Property, New Project Concession Property or Additional Concession Property, the Company shall, at all times, have the non-exclusive licence to access and use such Initial Concession Property, KCRC shall grant to the Company the non-exclusive licence to access and use such New Project Concession Property on and from the relevant New Project Effective Date, and the Company shall have the non-exclusive licence to access and use any such Additional Concession Property on and from the date on which such Additional Concession Property becomes Additional Concession Property.

***Initial Concession Property***

KCRC shall remain the legal and beneficial owner of all and any Initial Concession Property and all and any New Project Concession Property throughout the Concession Period unless the Company purchases that Initial Concession Property or New Project Concession Property pursuant to any right to purchase Concession Property provided under the Service Concession Agreement.

***Additional Concession Property***

The Company will be the legal and beneficial owner of Additional Concession Property. The Service Concession Agreement sets out the regime for compensation payable by KCRC to the Company if Additional Concession Property is returned to KCRC at the end of the Concession Period.

***Right to Purchase Concession Property***

At any time or times during the Concession Period, the Company shall (subject to agreement on terms with KCRC) have the right or option: (a) to purchase any Concession Property (other than the Additional Concession Property) from KCRC; and (b) for an asset which constitutes Additional Concession Property, to require such asset to cease being subject to the obligations and restrictions applicable to Additional Concession Property under the SCA, and, in each case, the terms (including price) in relation to such right or option, and any consequential adjustments to the Concession Payments (if any), shall be such as are agreed between the Company and KCRC at the relevant time or times.

*KCRC Railway Land No Longer Required in Connection with the KCRC Services*

The Service Concession Agreement provides for a redelivery and surrender mechanism if, amongst other things, for a period of 6 months, the Company does not use a material portion of the KCRC Railway Land and/or a material part of any building forming part of the Concession Property in connection with the KCRC Services and, does not expect, for the immediately following period of 6 months, to use such material portion of the KCRC Railway Land and/or such material part of such building in connection with the KCRC Services.

**Representations and Warranties given by the Company**

*Representations and Warranties*

The Company represents and warrants in favour of KCRC that, subject to certain provisions contained in the Merger Framework Agreement relating to third party claims and KCRC not breaching its obligations in respect of certain covenants in the SCA made relating to the Concession Property or operations:

- it has satisfied itself about all risks, liabilities, contingencies and circumstances concerning the Concession Property and the land on which the Concession Property is situated and the performance of the KCRC Services and it shall have no claim against KCRC (or any of its affiliates) or the Government for any such risk, liability, contingency or other circumstance;

- it accepts in all respects the existing state and condition of the Concession Property and the land on which any of the Concession Property is situated and shall take the same on an "as is" basis; and

- all authorisations required to be obtained to enable it to use and operate the Concession Property have been obtained or effected and are in full force and effect.

*Indemnity*

The Service Concession Agreement provides that, subject to certain conditions contained therein, the Company indemnifies KCRC (and its affiliates, employees, agents and contractors) against all losses incurred or suffered by such persons arising from a breach by the Company (or its affiliates) of the representations and warranties described above.

**Risk Allocation**

The Service Concession Agreement provides that, subject to certain provisions contained in the Merger Framework Agreement relating to third party claims and KCRC not breaching certain of its obligations in respect of its covenants made relating to the Concession Property or operations:

- the Company shall bear all risks, liabilities and/or costs whatsoever associated with or arising from the Concession Property and the land on which any of the Concession Property is located during the Concession Period;

- neither KCRC nor the Government shall in any circumstances be liable to provide the Company with any replacement goods or materials or land or parts at all; and

- neither KCRC nor the Government shall bear any responsibility or liability for any of the Concession Property during the Concession Period.

In addition, the Company shall assume the risks, liabilities and costs arising from:

- the suitability of and title to the Concession Property and the land on which any of the Concession Property is situated;
- the physical state and condition of the Concession Property and the land on which any of the Concession Property is situated;
- any defects (inherent, patent, latent or otherwise) in any Concession Property;
- the quality of any facilities, installations, services or structures incorporated in or employed as or to be incorporated in or employed as part of the KCRC System or the Concession Property and the land on which any of the Concession Property is located;
- safety requirements and matters relating to air, water and land;
- the availability of facilities, installations, services and utilities required for the use and operation of the KCRC System and/or the Concession Property; and
- any requirements or approvals or the lack thereof under any applicable law or regulation,

and agrees that the existence of any condition, whether or not foreseeable by an experienced concessionaire, shall not:

- entitle the Company to refuse to accept the Concession Property or the land on which any of the Concession Property is located for all purposes of the Service Concession Agreement;
- give rise to any claim against KCRC or the Government under any of the Transaction Agreements; or
- give rise to any claim for any reduction in the amount of the Concession Payments.

The Company shall not be relieved in any way from any obligation under the Service Concession Agreement should any information whether obtained from KCRC or the Government or otherwise be incorrect or insufficient.

Subject to certain provisions contained in the Merger Framework Agreement relating to third party claims and subject to KCRC not breaching its obligations in respect of its covenants made relating to the Concession Property or operations, the Company waives, as between itself, KCRC and the Government all its rights in respect of any warranty or representation, express or implied, on the part of KCRC or the Government and all claims against KCRC or the Government in respect of or out of the operation or performance of the Concession Property.

**The Company's Rights and Obligations**

The Service Concession Agreement provides certain additional rights and obligations of the Company, including in relation to:

- the maintenance and retention of records;
- information and reporting covenants relating to the Capex Threshold, defaults, material adverse circumstances, litigation and other information required by KCRC to enable KCRC to comply with laws and regulations;
- auditing;

- operation and maintenance of the Concession Property;
- disposal of Concession Property and the use of disposal proceeds;
- restrictions on the creation of security interests over the Concession Property;
- restrictions on parting with possession and sub-licensing certain Concession Property;
- rights of non-interference by KCRC (subject to certain conditions);
- rights to access and use KCRC Railway Land pursuant to a licence granted by KCRC; and
- apportionment of Government rates or rent relating to Concession Property pre and post Merger Date.

The Company is required at all times to maintain insurance in respect of Concession Property in accordance with the Service Concession Agreement.

**KCRC's Rights and Obligations**

The Service Concession Agreement provides certain additional rights and obligations of KCRC, including in relation to:

- limitation on disposals of any Concession Property;
- restrictions on the creation of security interests over the Concession Property;
- having no responsibility for the daily operations and maintenance of the Concession Property;
- rights of inspection in the event of breaches by the Company of the Service Concession Agreement or the Operating Agreement or if the Company is in default under the Franchise;
- the passing to the Company of notices, correspondence, orders or inquiries relating to the Concession Property which are received by KCRC on or after the Merger Date; and
- exercise of rights and performance of obligations under the KCRC Ordinance.

**Intellectual Property Rights**

The Service Concession Agreement contains provisions in relation to intellectual property rights. KCRC grants to the Company on a royalty-free basis, an exclusive licence to use certain intellectual property. Except in the case of intellectual property which is to be licensed for a transitional period, the licence will be coterminous with the Concession Period.

KCRC shall also provide the Company with copies of all documents and other media in KCRC's possession or control on which intellectual property that is Concession Property in the nature of know-how is recorded or incorporated.

Subject to certain conditions, the Company indemnifies KCRC (and its affiliates, employees, agents and contractors) on demand against all loss suffered or incurred by any of them as a result of any actual or alleged infringement of any Intellectual Property Right in connection with the provision by the Company of the KCRC Services or the Company's use of any Concession Property during the Concession Period. The Service Concession Agreement contains provisions, pursuant to which related claims are to be conducted.

## Liability

### *Defects*

The Service Concession Agreement provides that subject to certain conditions, KCRC shall not be responsible for or liable to the Company for the condition of the Concession Property as at the date of its delivery to the Company; or any loss of any kind or nature caused directly or indirectly by the Concession Property or any part thereof or any inadequacy thereof for any purpose or any deficiency or defect therein (whether patent, latent, inherent or otherwise) or the use or performance thereof or any repairs, servicing or otherwise thereto or any delay in or interruption or loss of use thereof or any loss of business or other consequential damage or any damage whatsoever or howsoever caused.

### *Indemnity*

Subject to certain conditions, the Company shall be responsible for and shall release and indemnify KCRC (and its affiliates, employees, agents and contractors) from and against losses incurred or suffered by any of them which arises directly or indirectly in respect of the Concession Property or out of its state, possession, use, performance, transportation or disposal or out of or in consequence of or in connection with any act, omission or negligence of the Company, its affiliates, employees, agents or contractors in:

- using, operating or maintaining the KCRC System and/or the Concession Property;
- designing, acquiring, constructing or otherwise creating any Additional Concession Property or any New Project Concession Property;
- providing the KCRC Services; or
- performing or failing to perform any of its obligations under the Service Concession Agreement.

The Company is not responsible for such matters if and to the extent such loss arises from the fraud or bad faith of KCRC or its affiliates, employees, agents or contractors (except where the agent in question is the Company and/or any of its affiliates acting as KCRC's agent pursuant to the Outsourcing Agreement, the KSL Project Management Agreement, the West Rail Agency Agreement and/or any other agreement or arrangement) or KCRC breaching its obligations in respect of certain covenants made relating to the Concession Property or operations.

## Remedies

The Service Concession Agreement provides that there shall be no default or breach by the Company of its obligation to make payments on the due date under the Service Concession Agreement if the failure is caused by the error or fault of a person other than the Company (or its affiliates, agents or contractors) and if payment is made within 7 business days of the original due date.

The Service Concession Agreement provides that there is no contravention or breach by the Company of its obligations in respect of disposals of Concession Property if the Company remedies any failure to comply with such obligations within 30 days of the Company becoming aware of the disposal constituting the failure.

The Service Concession Agreement provides for general remedies for breaches of its terms by the Company and/or KCRC.

***Specific performance***

The Company and KCRC acknowledge and agree that monetary damages alone shall be an insufficient remedy and, subject to an order of the court, specific performance shall be the appropriate remedy in the event that (i) the Company is in breach of its obligation to provide the KCRC Services to the Required Standards applicable to the KCRC System, or fails or refuses to return the Concession Property to KCRC upon the expiry or termination of the Concession Period, or is otherwise in breach of its return requirements, and/or provision of access obligations following termination or expiry of the Concession Period; or (ii) KCRC enters onto the KCRC Railway Land in breach of its obligations under the Transaction Agreements.

**Consequences of Termination or expiry of Concession Period**

The Service Concession Agreement provides the respective obligations of the Company and KCRC upon termination or expiry of the Concession Period regarding the return of Concession Property, respective access rights, arrangements in respect of intellectual property and in the case of any New Projects, additional obligations which will be set out in the relevant Supplemental Service Concession Agreement.

**Compensation**

Except as specifically provided in the Service Concession Agreement, no compensation will be payable by KCRC in respect of any Additional Concession Property upon the expiry or termination of the Concession Period. The Service Concession Agreement provides that, subject to certain conditions, upon the Company fulfilling the relevant return requirements as they apply to Concession Property, KCRC shall compensate the Company at the end of the Concession Period for expenditure on Additional Concession Property that is actually incurred by the Company in excess of the Capex Threshold.

Any agreement or determination as to the amount of the compensation payable by KCRC (if any) in respect of any Additional Concession Property upon the expiry or termination of the Concession Period shall represent the sole entitlement of the Company to compensation from KCRC and the Company shall have no other rights or remedies against KCRC and KCRC shall have no other liability to the Company, whether under the Service Concession Agreement, any other Transaction Document or at law, in respect of compensation payable in respect of Additional Concession Property upon the expiry or termination of the Concession Period.

**Assignment and sub-contracting**

KCRC may (without the Company's consent), assign or grant a security interest over its rights, including the receivables, under the Service Concession Agreement.

Except in the case of certain permitted sublicences, the Company shall not assign its rights or obligations under the Service Concession Agreement nor grant any interest in the Service Concession Agreement.

## C) SALE AND PURCHASE AGREEMENT

The Sale and Purchase Agreement was entered into on the Signing Date between the Company and KCRC.

The Sale and Purchase Agreement contains the detailed provisions relating to the purchase of the Purchased Rail Assets by the Company from KCRC. The Sale and Purchase Agreement covers the matters set out below.

**Effective Date**

The Sale and Purchase Agreement is conditional upon each of the other Transaction Agreements (other than certain Transaction Agreements which will be entered into after the Merger Date) becoming effective on the Merger Date.

**Sale and Purchase of Purchased Rail Assets**

The Company has agreed to purchase and KCRC has agreed to sell the Purchased Rail Assets pursuant to the terms of the Sale and Purchase Agreement. The Purchased Rail Assets include (in each case as more particularly defined in the Sale and Purchase Agreement) all the property and assets of KCRC (including, business plant and machinery, tools and equipment, stock, stores and spares, intellectual property and business information and records), shares in the KCRC Subsidiaries (which subsidiaries hold, amongst other things, the Category 1A Properties and act as property managers), and all those contracts of KCRC which are to be vested (by statute), novated and assigned to the Company with effect from the Merger Date but excluding the Category 1 Properties, the Category 2 Properties, the Category 3 Properties, the Excluded Assets, the Concession Property and the West Rail Agency Agreement.

**Intellectual Property Rights**

The Sale and Purchase Agreement also provides for the assignment by KCRC of certain Intellectual Property Rights to the Company and the transfer to the Company of certain designs, documents, calculations and drawings, and other items (or copies thereof) in KCRC's control or possession in or on which Intellectual Property Rights (to be assigned or licensed to the Company) subsists or is embodied or incorporated. KCRC shall further provide the Company with copies of all documents and other media in which purchased know-how is recorded or incorporated.

**Consideration**

The consideration for the sale of the Purchased Rail Assets (excluding the shares in the KCRC Subsidiaries) forms part of the Upfront Payment which, under the terms of the Service Concession Agreement, the Company has agreed to pay to KCRC on the Merger Date. The consideration for the sale of the shares in the KCRC Subsidiaries forms part of the consideration for the Property Package which under the terms of the Merger Framework Agreement the Company has agreed to pay to KCRC on the Merger Date.

**Obligations of the Company after Completion**

Except as otherwise provided in the Merger Framework Agreement and the Sale and Purchase Agreement, the Company undertakes to KCRC that it will properly perform, assume and pay and discharge when due, and indemnify KCRC against, all obligations and liabilities of KCRC under the contracts novated or assigned to the Company which are to be discharged by KCRC at any time on or after the Merger Date under the terms of those contracts.

Subject to the terms of the Merger Framework Agreement regarding third party claims, KCRC shall continue to be responsible for and shall promptly discharge all debts, liabilities and obligations which, prior to the Merger Date, are debts, liabilities or obligations of KCRC and are not assumed by the Company under the express terms of the Sale and Purchase Agreement or any other Transaction Agreement or under the Rail Merger Ordinance (even if assumed by the Company by operation of law (other than the Rail Merger Ordinance)) and shall indemnify the Company against all liabilities, losses, charges, costs, claims or demands (including loss of sales or diminution in the value of the relevant business) in respect of all such debts, liabilities and obligations.

**Transfer of Purchased Contracts**

Rights and obligations under contracts to be vested in the Company shall be so vested in accordance with the Rail Merger Ordinance. KCRC shall use reasonable endeavours to procure all relevant third parties enter into a novation contract, or (in the case of contracts to be assigned and where required) give consent, in respect of each contract which is to be novated or assigned to the Company.

**Apportionment**

Subject to the terms of the Merger Framework Agreement and the other terms of the Sale and Purchase Agreement and the other Transaction Agreements:

- the Company shall be responsible for (and shall indemnify KCRC in respect of) all liabilities of KCRC under the contracts which are to be vested in, or novated or assigned to, the Company or in relation to the Purchased Rail Assets which are to be discharged by KCRC at any time on or after the Merger Date; and

- KCRC shall be responsible for (and shall indemnify the Company in respect of) all liabilities of KCRC under the contracts to be vested in, or novated or assigned to, the Company or in relation to the Purchased Rail Assets which are to be discharged by KCRC at any time prior to the Merger Date.

**Tenancies**

The Sale and Purchase Agreement provides that if KCRC suffers loss in connection with a defaulting tenant in respect of a Category 1A Property then KCRC has the right to recover an amount from the relevant KCRC Subsidiary to the extent of the relevant rental deposit.

**Receivables**

The Company will generally not acquire receivables from KCRC other than those receivables due under contracts to be vested in the Company in accordance with the MTR Ordinance. However, KCRC shall supply to the Company full details of the non-acquired receivables and the Company will collect such non-acquired receivables as agent for KCRC during the period of two years immediately following the Merger Date. The Sale and Purchase Agreement sets out a procedure that the Company and KCRC will follow in order to facilitate the collection and distribution of the non-acquired receivables.

**Risk**

Without prejudice to the terms of the Merger Framework Agreement relating to KCRC Claims, MTRC Claims and Railway Project Claims, risk in the Purchased Rail Assets shall pass on the Merger Date.

**Employees**

The Sale and Purchase Agreement provides that all wages, salaries, employment contract gratuities, employer's liabilities in respect of Mandatory Provident Fund contributions and other periodic outgoings in respect of the KCRC's employees which relate to a period:

(i) on or after the Merger Date shall be borne or discharged by the Company; and

(ii) before the Merger Date shall be borne or discharged by KCRC.

KCRC indemnifies the Company against claims in respect of the employment of any of KCRC's employees at any time prior to the Merger Date by KCRC (other than where such claim arises by reason of any matter or event occurring on or after the Merger Date) and the breach of KCRC's obligations as set out in (ii) above. The Company indemnifies KCRC against any claim in respect of any breach of (i) above.

**KCRC's Warranties**

Pursuant to the Sale and Purchase Agreement, KCRC provides warranties in respect of the following:

- ownership of the shares in the KCRC Subsidiaries and Metropolis;

- certain corporate matters relating to the KCRC Subsidiaries;
- the audited financial statements of the KCRC Subsidiaries;
- with respect to the KCRC Subsidiaries, events since 31 December 2006; and
- ownership of Category 1A Properties.

**The Company's remedies**

The Company will not have the right to terminate the Sale and Purchase Agreement if it becomes aware that there has been any material breach of the warranties provided by KCRC or any other term of the Sale and Purchase Agreement but will be entitled to claim damages or exercise any other right, power or remedy under the Sale and Purchase Agreement or as otherwise provided by law.

**Limitations on KCRC's liability**

The Company will not be entitled to damages or other payment in respect of any claim or claims under any of the warranties provided by KCRC in respect of any individual claim (or a number of claims) unless and until the aggregate amount of all such claims exceeds HK$50,000,000. The total aggregate liability of KCRC under the warranties provided by KCRC shall not in any event exceed an amount equal to the aggregate value of the Category 1A Properties set out in the property valuation report contained in Appendix VIII of this Circular that being HK$1,141 million. The Company will not be able to make any claims in respect of any of the warranties provided by KCRC after 18 months from the Merger Date.

**Books and Records of the KCRC Subsidiaries**

The Sale and Purchase Agreement contains rights and obligations of the Company and KCRC with respect to the books and records proprietary to the KCRC Subsidiaries.

**Inter-group guarantees**

KCRC shall use all reasonable endeavours to procure the absolute and unconditional release and discharge in full on the Merger Date (or as soon as reasonably practicable thereafter) of each guarantee, indemnity, assurance, undertaking, commitment or other security obligation granted or entered into by any KCRC Subsidiary in relation to or arising out of any obligation or liability of KCRC or any of its subsidiaries (excluding the KCRC Subsidiaries) (or of their employees, agents, advisers or persons otherwise connected with them) (each a "**KCRC Subsidiary Guarantee**") at KCRC's cost. Prior to any such release, KCRC has undertaken (i) to pay to the Company any losses suffered and any and all liabilities, costs and expenses incurred by the Company or any KCRC Subsidiary arising under any KCRC Subsidiary Guarantee; and (ii) not to enter into any variation of any agreement which may have the effect of varying any KCRC Subsidiary Guarantee without the prior written consent of the Company.

The Company shall use all reasonable endeavours to procure the absolute and unconditional release and discharge in full on the Merger Date (or as soon as reasonably practicable thereafter) of each guarantee, indemnity, assurance, undertaking, commitment or other security obligation granted or entered into by KCRC or any of its subsidiaries (excluding the KCRC Subsidiaries) in relation to or arising out of any obligation or liability of any of the KCRC Subsidiaries (or of their employees, agents, advisers or persons otherwise connected with them) (each a "**Retained KCRC Group Guarantee**"), at the cost of the Company. Prior to any such release, the Company has undertaken (i) to pay KCRC an amount equal to any losses suffered and all liabilities, costs and expenses incurred by KCRC or any of its subsidiaries (excluding the KCRC Subsidiaries) arising under any Retained KCRC Group Guarantee after the Merger Date; and (ii) not to enter into any variation of any agreement which may have the effect of varying any Retained KCRC Group Guarantee without the prior written consent of KCRC.

### Procedure for making payments

The procedure for making any payments under the Sale and Purchase Agreement shall follow the payment mechanics set out in the Merger Framework Agreement.

### Stamp Duty

Stamp duty on the sale and purchase of the shares in the KCRC Subsidiaries shall be borne equally by KCRC and the Company.

### Governing Law and Jurisdiction

In accordance with the Merger Framework Agreement, the Sale and Purchase Agreement is governed by the laws of Hong Kong.

## D) OPERATING AGREEMENT

The Operating Agreement was entered into on the Signing Date between the Company and the Secretary for and on behalf of the Government.

The Operating Agreement, is based on the Existing Operating Agreement which currently governs certain aspects of the design, construction, maintenance and operation of the MTRC Railway. The Operating Agreement contains the detailed provisions for the design, construction, maintenance and operation of the Integrated Railway. With effect from the Merger Date the Existing Operating Agreement will terminate and the Operating Agreement will take effect. The Operating Agreement covers the matters set out below.

### Franchise

The Operating Agreement is conditional upon each of the other Transaction Agreements (other than certain Transaction Agreements which will be entered into after the Merger Date) becoming effective on the Merger Date.

In the event of revocation of any part of the Franchise relating to the KCRC Railway, the Operating Agreement shall no longer apply to that part of the Franchise so revoked.

The Operating Agreement provides that an application by the Company to extend the Franchise shall be submitted to the Secretary in accordance with the MTR Ordinance who will, subject to certain provisions, recommend to the Chief Executive in Council that the Franchise should be extended for a period of 50 years from the effective date if:

- a project agreement has been signed in relation to a New Project with an estimated capital cost of at least HK$15 billion (as adjusted pursuant to the Operating Agreement);

- the Board has approved certain capital works with a total estimated capital cost of at least HK$15 billion (as adjusted pursuant to the Operating Agreement) ("**Major Capital Works**") and the Secretary has notified the Company that the capital works qualify as Major Capital Works; and

- the Company has incurred certain capital expenditure of at least HK$15 billion (as adjusted pursuant to the Operating Agreement) over the preceding ten years.

In making his recommendation, the Secretary must take account of all reasonable representations from the Company as to why, and from which date, the Franchise should be extended.

No payment is required from the Company for any extension of the Franchise. For the period up to the expiry date (as it is prior to the extension), the terms of the Franchise will not be amended and for the period commencing thereafter, the terms of the Franchise shall be substantially the same (except in certain circumstances) unless the Company and the Secretary agree otherwise.

Upon extension of the Franchise and subject to the Government's prevailing land policy on the date on which the Franchise is extended and the Chief Executive in Council's approval is given, certain consequential amendments will be made to certain other agreements between the Government and the Company in relation to the Integrated Railway to ensure that the period specified in each such agreement is coterminous with the extended Franchise period.

**Access Regime**

The Operating Agreement contains obligations on both the Company and the Government to provide for a workable, open, non-discriminatory, efficient approach for the Government and the Company to negotiate and agree access to common property of both the MTRC Railway and KCRC Railway in the event of the suspension of the Franchise (whether wholly or in part), revocation of the Franchise, or expiry of the Franchise and to provide an efficient, effective and binding resolution process in the event that the Government and the Company are unable to agree a regime for access to such common property.

**Design, Construction and Maintenance of the Railway**

The Operating Agreement provides certain requirements that the Company must meet in connection with the design, construction and maintenance of the railway.

The Company must make provision for and maintain more than one source of electric power supply, take all proper precautions in the use of electrical energy and all reasonable precautions in constructing, placing and maintaining electric lines.

The Company must provide and maintain adequate facilities in the control centres, manned by trained personnel, for the safe regulation, control and direction of trains and persons using or employed in the operation of the railway. The Company must provide and maintain adequate means to prevent the flooding of the railway premises. The Company must also provide adequate depot facilities and equipment.

A number of environmental conditions, such as noise levels, air quality and temperature, must be monitored by the Company and the Company is also required to provide adequate lighting and ventilation in the certain areas of the railway premises.

The Company shall (other than in relation to Light Rail) provide and maintain adequate accommodation, facilities and means of communication for members of the Hong Kong Police Force (which are provided as at the Merger Date and at all stations which are constructed, expanded, or to the extent reasonably practicable renovated after the Merger Date), as well as providing access to the Company's closed circuit television monitors in its control centres and stations and elsewhere as agreed between the Company and the Commissioner of Police from time to time. The Government has agreed to procure that the Hong Kong Police Force continues to provide a police service for the railway in the same manner as that provided at the Merger Date.

**Passenger services**

***Disruptions to train services***

The Operating Agreement provides that the Company must report to the Commissioner for Transport and Commissioner of Police the emergency closure, or anticipated emergency closure, of any part of the railway premises and any interruption or delay which may affect the safe and efficient conveyance of passengers. The Company must also notify the media if it considers that such notification will be of assistance to passengers and would not adversely affect the safe and efficient operation of the railway. The Company must consult the Commissioner for Transport on any new arrangements by the Company which may reasonably be considered as adversely affecting the normal operation of the railway.

***Train service arrangements***

The Company is required to provide a minimum level of service in terms of the hours of operation of train services and the capacity of the service it provides. These minimum levels are prescribed in the Operating Agreement. Where the Company proposes to modify the level of service it provides in a material way, it can only do so if the Commissioner for Transport has not objected. The Operating Agreement also provides for certain consultation and notification requirements if the Company proposes to make cancellations with respect to a cancellation of a Light Rail route and curtailment/truncation, or reduction in frequency and/or operating hours in respect of the TSA Buses.

The Operating Agreement imposes obligations on the Company regarding:

- keeping the railway premises in a clean and sanitary state;
- providing a comfortable passenger environment;
- providing and maintaining adequate and efficient communication facilities between control centres and, for example, trains in operation, stations, police facilities and transport co-ordination centres;
- ensuring that noise and vibration is kept to a minimum;
- ensuring efficient and effective collection of fares;
- ensuring that ticket and cash handling facilities are safe and secure; and
- providing escalators and lifts for safe, efficient and effective transportation of passengers (other than in respect of Light Rail).

***Performance requirements***

*General*

The Company will be required to meet certain performance requirements ("**Performance Requirements**") in relation to the railway-related services it provides. These Performance Requirements cover the following matters:

- *train service delivery* which is a measure of the actual train trips run by the Company against the train trips scheduled to be run by the Company;
- *passenger journeys on time* which is a measure of passengers journeys which are delayed by at least five minutes;

- *train punctuality* which is a measure of train trips delayed by at least five minutes in the case of the Airport Express Line, by at least two minutes in the case of the other MTRC Railway lines, by at least three minutes in the case of ER and WR and by at least five minutes in the case of Light Rail;

- *add value machine reliability* which is a measure of the total operating hours of add value machines;

- *ticket machine reliability* which is a measure of the total operating hours of ticket machines;

- *ticket gate reliability* which is a measure of the total operating hours of ticket gates;

- *escalator reliability* which is a measure of the total operating hours of escalators; and

- *passenger lift reliability* which is a measure of the total operating hours of passenger lifts.

Each year, the Company's railway operations for the previous year will be measured against the Performance Requirements and the Company may be required to explain failures to meet any Performance Requirement to the Commissioner for Transport and provide information on the actions it has taken, or is proposing to take, to improve its performance. In addition, the Company must inform the Commissioner for Transport of any likely failure to meet a Performance Requirement.

The Company will not be regarded as having failed to meet a Performance Requirement if the failure results (whether directly or indirectly and whether in whole or in part) from the occurrence of certain exemption events, including war, hostilities, natural disasters, disorder, industrial action, loss or diminution of power supply, disruption caused by any member of the public or any other cause or event beyond the control of the Company provided that the Company shall not be entitled to rely on an exemption event if that event occurred as a result of a breach of contract or negligence, or was caused or materially contributed to, by or on the part of the Company. In addition and subject to the foregoing proviso, for a period of two years from the Merger Date only the Company will not be regarded as having failed to meet a Performance Requirement, if the failure results from any defect in (a) any of the properties and assets vested in the Company under the Rail Merger Ordinance; (b) any of the Purchased Rail Assets which are acquired by the Company pursuant to the Sale and Purchase Agreement; or (c) any of the Concession Property which are subject to the Service Concession Agreement, which exists as at the Merger Date and was not reasonably discoverable by the Company between 11 April 2006 and the Merger Date. However, the Company must use its reasonable endeavours to prevent the occurrence of these events, to mitigate their effects and to take steps to remedy them.

*Review of Performance Requirements*

The Operating Agreement contains provisions which allow for the adjustment of the Performance Requirements under specified circumstances. Each year, the Company and the Commissioner for Transport are required jointly to review the Performance Requirements, taking into account the results of customer surveys covered by reports carried out by the Company, the opening of any New Projects or the introduction of any New Technology (as defined below) and any other relevant circumstances, and may agree that the Performance Requirements, or their application, may be changed temporarily.

In addition, the Company or the Commissioner for Transport can request an additional joint review of the Performance Requirements in certain circumstances, such as upon introduction of new or substantially modified passenger train designs, new or substantially revised methods of automatic train control and following substantial alterations, extensions, additions or modifications to any material infrastructure, plant or equipment.

*New railway projects and new technology*

Where the Company introduces a New Project and the introduction of that New Project is likely materially to affect the Company's ability to meet any Performance Requirement, then in determining whether the Company has met any Performance Requirement, no account shall be taken of any New Project during the period of introduction of that New Project and for two years from the commencement of operations on that New Project. Where operations on a New Project commence at any time during the period beginning two years immediately before the Merger Date and the introduction of that New Project is likely materially to affect the Company's ability to meet any Performance Requirement, then in determining whether the Company has met any Performance Requirement, no account shall be taken of that New Project during the period of introduction of that New Project and for two years from the commencement of operations on that New Project.

Where new or substantially changed technology (the purpose of which is to assist in improving or maintaining the railway) is introduced in connection with the operation of the railway ("**New Technology**") and the introduction of that New Technology is likely materially to affect the Company's ability to meet any Performance Requirement in respect of the operation of that or any other part of the railway (the "**Relevant Part of the Railway**") during the period when that New Technology is being introduced, then, in determining whether the Company has met any Performance Requirement no account shall be taken of the operation of the Relevant Part of the Railway for two years from the date of the introduction of that New Technology. Where New Technology is introduced at any time during the period beginning two years before the Merger Date and the introduction of such New Technology is likely materially to affect the Company's ability to meet any Performance Requirement in respect of the Relevant Part of the Railway during the period when that New Technology is being introduced, then in determining whether the Company has met any Performance Requirement, no account shall be taken of the operation of the Relevant Part of the Railway for two years from the date of the introduction of that New Technology.

Before the commencement of operations on any New Project or the introduction of any New Technology, the Company is required to establish to the reasonable satisfaction of the Commissioner for Transport specific performance requirements for:

- that New Project ("**New Project Requirements**"); and
- the operation of the Relevant Part of the Railway ("**New Technology Requirements**"),

and those New Project Requirements or New Technology Requirements will be applicable in respect of that New Project or the operation of the Relevant Part of the Railway for two years from the commencement of operations on that New Project or the date of the introduction of that New Technology. The Company is required to base those New Project Requirements or New Technology Requirements on the best information available to the Company, including the outcome of any performance trials and relevant contract specifications.

***Customer Services Pledges***

The Operating Agreement requires the Company to establish, publish annually and strive to meet customer service pledges ("**Customer Service Pledges**"), which relate to the same matters as the Performance Requirements (namely train service delivery, passenger journeys on time, train punctuality, add value machine reliability, ticket machine reliability, ticket gate reliability, escalator reliability and passenger lift reliability) as well as the following additional matters:

- train reliability;
- ticket reliability;
- temperature and ventilation levels;

- railway cleanliness; and
- passenger enquiry response time.

In relation to Light Rail, the Company is required to maintain Customer Service Pledges in relation to train service delivery, train punctuality, add value machine reliability, ticket machine reliability, Octopus Card process validation machines, temperature and ventilation levels, railway cleanliness and passenger enquiry response time. In relation to the TSA Buses, Customer Service Pledges, are required to be maintained in relation to service delivery and cleanliness.

The Company is required to publish data which measures its actual performance against the Customer Services Pledges on a quarterly basis.

Unlike the Performance Requirements, the Customer Service Pledges are voluntary targets established by the Company itself and do not themselves constitute contractual obligations relating to performance.

#### *Other Matters Relating to Passenger Services*

To further enhance the service provided by the Company, it must take steps to measure, publish and provide reports on customer satisfaction, handle passenger complaints and suggestions and provide signage and information to its passengers.

The Commissioner may request the Company to review its service arrangements and to consider suggestions for service changes.

The Operating Agreement provides that the Company shall establish, and comply with, procedures for consulting relevant groups representing passengers with physical disabilities and procedures for the annual review of its facilities with respect to passengers with physical disabilities.

### Safety Management

#### *General*

The Operating Agreement contains provisions as to safety management and requires the Company to design, construct, operate and maintain the railway having due regard to the safety of the railway and of persons using or employed on the railway to the reasonable satisfaction of the inspector (the "**Inspector**") appointed under the MTR Ordinance.

#### *Instruction manuals*

Any documentation the Company produces which relates to procedures in respect of safety, emergency and security matters must be provided to the Inspector. Any revision of instruction manuals can only be made following consultation with the Inspector (and, in certain circumstances, the Commissioner of Police and the Director of Fire Services).

#### *Rescue and breakdown equipment*

The Company must provide adequate vehicles and equipment for the safe and speedy recovery of defective trains and equipment and for the rescue of passengers and persons employed on the railway. Such vehicles and equipment must be effective and maintained in an efficient working condition and, if necessary, attended and operated by trained personnel.

***Maintenance procedures***

The Company is required to establish, operate and maintain a maintenance management system, taking into account good practices of railway systems in other cities as far as reasonably relevant, for the maintenance of facilities, systems and trains to minimise safety risks. The Company must ensure that maintenance work is carried out by competent personnel.

***Provision of railway staff***

The Company must have on duty staff in such numbers and with such training and experience as will ensure the proper control and operation of the railway and the safety of persons using or employed on it.

***Opening of the railway and new railway projects***

The Company shall not:

- open any new part of the railway;

- commence operations on any New Project or open any station or junction; or

- bring into use any additional or modified major facilities, equipment, systems or trains or introduce New Technology which have, or are likely to have, an impact on the safety of the railway or on the safety of persons using or employed on the railway,

until the Inspector confirms in writing to the Secretary that the same is in all respects safe and in sound condition to be used for the conveyance of passengers and their luggage and goods.

***Contingency plans***

The Company is required to develop and maintain contingency plans to be implemented in the event of a breakdown, accident, emergency, any other incident or any other substantial or important matter on the railway or railway premises. If, after the Merger Date, the Company develops any new contingency plan for any matter which (a) may affect the safety of passengers on the railway or result in the interruption or delay in the train service and (b) is not already dealt with by any of the contingency plans which are then in place, the Company shall, as soon as reasonably practicable, consult the Government department(s) the functions of which are relevant to such new contingency plan before finalising such new contingency plan.

The Operating Agreement provides a non-exhaustive list of the arrangements which must be included in contingency plans.

**Land**

***Land for New Projects and Property Development Rights***

For any New Project to be implemented by the Company, the Government and Company will agree the detailed terms upon which the land required for the construction and operation of that New Project will be provided to the Company at a land premium in accordance with the Government's land policy at the relevant time. The Government has acknowledged that property development has been and is expected to continue to be, important for the commercial viability of New Projects as well as for operational and technical reasons. The Government and the Company will also agree the detailed terms relating to what property development rights (if any) should be provided to the Company.

***Land Premium Amounts***

The Government has agreed that, for so long as its current land policy is maintained (and the Company has acknowledged that the Government may amend its land policy from time to time), land premium amounts payable by the Company will be assessed on a ''full market value'' basis ignoring the presence of the railway for the first land grants made by the Government for property development rights in relation to each New Project granted to the Company and, if applicable, for the first premium amount payable for property development rights in relation to each development phase of such New Project (in each case, other than for depot sites). For this purpose, ""full market value" basis ignoring the presence of the railway" means the full market value as assessed by the Government without having regard to any effect the presence of the railway may have on the site being valued. For so long as the Government's current land policy is maintained, for railway depot use at depot sites, the land premium amounts will be assessed on an ''industrial use'' basis with a minimum plot ratio of 1 and for the sites of running lines and stations, the land premium amounts will be assessed at nominal premium.

**New Railway Projects**

***General***

Subject to the MTR Ordinance, it is acknowledged that, when undertaking New Projects and/or operating New Railways, the Company will require an appropriate commercial rate of return. The Government agrees that it will not require the Company to construct any New Project and/or operate any New Railway except in certain circumstances and provided that the parties agree on the commercial rate of return. The Government acknowledges that, in order for particular New Projects and/or New Railways to earn a commercial rate of return and in order for the Company to maintain its financial standing and profile, financial and other support for those New Projects and/or New Railways from the Government may be required. If the Government invites the Company to operate a New Railway pursuant to a New KCR Project or a New Separate Project, under a service concession to be granted to the Company by KCRC, the Government or a Government entity, the Company shall be obliged to operate the New Railway under the concession approach in accordance with the Operating Agreement and the relevant future agreement relating to that service concession.

***New MTR Projects***

For any New MTR Project, the Government has agreed that:

- the Company shall, on an exclusive basis, be invited to undertake the New MTR Project under the ownership approach and to submit a proposal to the Government for that project;

- if the Company submits a proposal to the Government, the Government and the Company will commence negotiations on an exclusive basis as soon as reasonably practicable thereafter with a view to agreeing the terms upon which the Company will finance, construct and operate the New Railway pursuant to that New MTR Project (including the nature and terms of any appropriate financial and other support the Government may provide to the Company); and

- if an agreement in respect of the matters referred to in the paragraph above cannot be reached within a reasonable time period, the Government may cease negotiations with the Company and invite other persons to undertake that New MTR Project.

***New KCR Projects***

For any New KCR Project, the Government may (in its absolute discretion but subject as described below) adopt the ownership approach or the concession approach.

For any New KCR Project, in respect of which the Government decides to adopt the ownership approach:

- the Company shall, on an exclusive basis, be invited to submit a proposal to the Government for that New KCR Project; and

- if the Company submits a proposal to the Government, the Government and the Company will commence negotiations on an exclusive basis as soon as reasonably practicable thereafter with a view to agreeing the terms upon which the Company will finance, construct and operate the New Railway pursuant to that New KCR Project (including the nature and terms of any appropriate financial and other support the Government may provide to the Company); and

- if an agreement in respect of the matters referred to in the paragraph above cannot be reached within a reasonable time period, the Government may decide (in its absolute discretion) to (a) invite third parties each to submit a proposal to the Government to undertake such New KCR Project under the ownership approach or (b) invite the Company to operate the New Railway in respect of such New KCR Project under the concession approach.

For any New KCR Project in respect of which the Government decides to adopt the concession approach and the Government is considering granting the service concession in respect thereof to the Company, the Government shall invite the Company to operate the New Railway through the Service Concession.

***New Separate Projects***

For any New Separate Project, the Government may (in its absolute discretion but subject as described below) adopt either the ownership approach or the concession approach.

For any New Separate Project in respect of which the Government decides to adopt the ownership approach, the Government may (in its absolute discretion) either (i) invite the Company to submit a proposal to the Government for that New Separate Project; or (ii) award the New Separate Project through an open tender process.

For any New Separate Project in respect of which the Government decides to adopt the concession approach, the Government may (in its absolute discretion) invite the Company and/or third parties to operate the New Railway in respect of such New Separate Project under the concession approach.

For any New Separate Project, the Government has agreed that:

- in the case of an award of a New Separate Project through an open tender process and in the case that the Government decides to adopt the concession approach, it may invite the Company and any other persons to submit a tender or proposal, on the same basis, for that New Separate Project;

- it will evaluate such submissions objectively on their merits;

- in evaluating any such submissions made by a person that is wholly or partially owned by the Government, it will assume that a commercial rate of return must be earned by that person;

- where support from the Government may be required by the Company for a New Separate Project that may be awarded to the Company, the Government and the Company will seek to reach agreement on terms for appropriate financial or other support before that New Separate Project is awarded to the Company; and

- where the Company has made a submission in respect of a particular New Separate Project and the Government awards that New Separate Project to a person other than the Company, it will, as soon as reasonably practicable, inform the Company of, and the reasons for, its decision but will have no obligation to inform the Company of any commercially sensitive information.

The Company has acknowledged that, for any New Separate Project the scope of which does not include the construction and/or operation of a transport interchange between the MTRC Railway or the KCRC Railway, and a part of another railway system but which does include:

- the construction and/or operation of a transport interchange between a part of that New Separate Project and a railway system other than the MTRC Railway or the KCRC Railway; and/or

- the construction and/or operation of (a) one or more new stations and (b) new track work which extends an existing line which forms part of a railway system other than the MTRC Railway or the KCRC Railway, or deviates from an existing line which forms part of a railway system other than the MTRC Railway or the KCRC Railway,

the Government may, in its absolute discretion, award that New Separate Project to the operator of that other railway system without inviting the Company to submit a tender or proposal.

***Concession Approach - Additional Concession Payments***

Unless otherwise agreed by the Company and the Government, for each New Separate Project or a New KCR Project that the Government invites the Company to operate under the service concession approach, the Company shall operate the New Railway in accordance with the following financial terms. Additional Concession Payments are to be determined on the basis of 90% of the discounted Net Cash Flow of the New Project, being discounted at a discount rate which reflects the Company's proposed commercial rate of return in relation to the New Railway (so as to enable the Company to make a commercial rate of return) and, where KCRC is the owner of the New Railway, are to be reflected in a similar structure as the payment structure under the Service Concession Agreement being in the form of fixed annual payments and variable annual payments.

***Entrustment agreement***

The Company shall be entrusted with the design and construction of the New Projects which are to be undertaken by the Company through the service concession approach, subject to the Government's approval and the Company and the Government agreeing on a price.

**Fares**

***Fare Adjustment Mechanism***: The Operating Agreement also contains the terms of the Fare Adjustment Mechanism. The principal terms are summarised as follows:

(a) *Direct drive fare adjustment formula*

A "direct drive" fare adjustment formula will be adopted. The FAM will provide that any adjustment to specified fares should be linked to changes in the Government Composite Consumer Price Index and changes in the Nominal Wage Index (Transport Services Sector) published by the Census & Statistics Department of Government, and taking into account a productivity factor.

The Fare Adjustment Mechanism will work as follows:

"Overall weighted fare adjustment rate = 0.5 * △ CCPI + 0.5 * △ wage index - t"

where:

"Overall weighted fare adjustment rate" is calculated based on the basket of specified "fares" on the Integrated Railway as set out in (b) below;

"△ CCPI" means the yearly percentage change in the Government Composite Consumer Prices Index;

"△ wage index" means the yearly percentage change in the Nominal Wage Index (Transport Services Sector); and

"t" is a productivity factor. The purpose of "t" is to incentivise the Company to achieve productivity gains. "t" will be deemed to be zero in the first five years following the Merger Date. "t" will have a value of 0.1% starting from the sixth year following the Merger Date. The value of "t" will not be subject to review until after the ninth anniversary of the Merger Date under the agreed review mechanism for the FAM.

(b) *Applicability of the Fare Adjustment Mechanism*

The FAM will, from the Merger Date, apply to specified fares on all existing and new railway lines on the Integrated Railway (other than the Airport Express Line (unless the fare is an Airport workers' fare), Ngong Ping 360, the intercity trains and those new railway lines which are New Separate Projects not intended for use by daily commuters for domestic travel. The inclusion or otherwise of such New Separate Projects will be agreed with the Government on a case-by-case basis). Light Rail and TSA Buses shall be subject to the application of FAM from the Merger Date.

For adjustments to fares of the Airport Express Line, the Company shall be subject to consultation requirements which are substantially the same as those set out in the Existing Operating Agreement.

The definition of "fares" for the purposes of the FAM shall include monthly passes (excluding promotional arrangements) and any "time of day" surcharge and/or discount introduced/removed by the Company (such as peak surcharges and non-peak discounts), but will exclude any promotional arrangements.

The Company can adjust certain fares within ±5 percentage points from the overall fare adjustment level determined by the FAM formula (provided that such fares may not be increased if the overall fare adjustment level is a negative number), subject to overall compliance of its specified fare basket with the FAM.

(c) *Trigger mechanism of fare adjustment*

If, in a given year, the overall fare adjustment rate under the FAM is within the range of ±1.5%, there shall be no fare adjustment and the unadjusted percentage shall be rolled over to the next annual fare review.

(d) *Adjustment of fares*

Fares subject to the FAM shall (subject to the above paragraph) be adjusted annually in accordance with the FAM. None of the Company's fares which are subject to the FAM, other than "time of day" surcharge or discounts, shall be adjusted more than once in any given year.

(e) *Independent expert certifications*

No later than two weeks prior to notifying the Transport Advisory Committee and the LegCo Transport Panel and making a public announcement of yearly fare adjustments to be made under the FAM, the Company shall provide to the Government two independent expert certifications with supporting data that the fare adjustments are in compliance with the FAM.

(f) *Review of FAM*

The FAM shall be subject to review every five years upon request by either the Company or the Government. If the Company and the Government do not reach agreement on amendments to the FAM within a specified period after commencement of the review, the prevailing FAM shall continue to apply.

(g) *Introduction or withdrawal of fares subject to the Fare Adjustment Mechanism*

For the introduction or withdrawal of fares subject to the FAM, the Company shall (i) consider the public acceptability of any proposed change; (ii) notify and consult with the Transport Advisory Committee and the LegCo Transport Panel on the price, terms and date of the introduction or withdrawal of the relevant fares; and (iii) make a public announcement of the proposed change no later than three weeks prior to the introduction or withdrawal of the relevant fares.

***Promotional fares***: The Company shall notify the Commissioner for Transport at least seven days prior to the implementation, or variation to prices, or termination, of promotional arrangements, except in the case of an arrangement which the Company considers to be of a compensatory nature or for operational purposes.

For the purposes of the above paragraph, a promotional arrangement means (i) any arrangement which (a) reduces the cost per journey of travel on the Network; (b) is considered by the Company to be of a promotional nature and (c) is intended by the Company to last for up to twelve months; or (ii) any arrangement which is from time to time agreed between the Company and the Commissioner for Transport to be a promotional arrangement.

**Compensation**

The Operating Agreement contains the detailed terms for the calculation of compensation that is payable by the Government to the Company in certain circumstances. Compensation payable for the loss of the relevant property will be equal to the higher of: (i) the fair value of the relevant property (assuming a willing buyer and seller and taking into account the earnings potential of the relevant property); and (ii) the depreciated book value of the relevant property, each as determined by an independent valuer. The independent valuer will also determine the amount of any compensation payable to the Company for the use of the relevant property. The amount of compensation payable to the Company for damage to any relevant property that is returned to the Company will be calculated by reference to the reasonable cost of remedying that damage. In the event of suspension of the Franchise relating to the KCRC Railway, any compensation payable by the Government to the Company will be determined by an independent valuer.

**Dispute settlement**

The process for settling disputes between the Government and the Company must begin with informal negotiation. If the dispute is not resolved through informal negotiation, the courts of Hong Kong shall have jurisdiction to settle the dispute. Both parties may agree to submit the dispute to arbitration, although neither the Company nor the Government is bound to do so.

**Assistance in ensuring continuity**

In order to facilitate the continuity of railway services on the expiry or revocation of the Franchise during the period beginning five years before the expiry of the Franchise and during the implementation of any revocation procedure, the Company must not take any action to frustrate the transition to any successor franchisee.

**Review of terms of Operating Agreement**

There is a procedure for a joint review of the terms of the Operating Agreement every five years from the Merger Date. At such reviews, the parties shall consider all relevant factors, including passengers' needs, the manner in which the Company may reasonably maintain a rate of technological and technical progress commensurate with good international practice having regard to the costs that would be incurred, the financial resources of the Company and prudent commercial principles. A joint review will also be carried out if either the Government or the Company requests that such a joint review be carried out. Where both parties agree, the terms of the Operating Agreement may be amended.

**Furnishing of records**

The Company must maintain records, including in relation to the Performance Requirements, Customer Service Pledges, passenger complaints and suggestions, the fare revenue, maintenance of trains and the number of trains in use, which may be inspected by the Secretary and the Commissioner.

**External audit**

Each year, an audited report prepared by the Company's external auditors must be submitted to the Commissioner as to whether the Company had internal controls and procedures in place which were adequate to enable the Company to measure and record, in all material respects, its compliance with the Performance Requirements and Customer Services Pledges.

**Regulations**

The Government will consult the Company and take account of all reasonable representations made by the Company, before the Secretary introduces regulations under the MTR Ordinance.

**Intercity Passenger Services and Freight Services**

Specified provisions (as described above) do not apply to the intercity passenger services and freight services. However, pursuant to the Operating Agreement the Company shall ensure that, as close as reasonably practicable:

- any train that it owns and operates on the intercity passenger service meets the levels of safety and general cleanliness required of it in respect of the services for the carriage of passengers provided by the Company in Hong Kong (the "**Domestic Services**") and has adequate standards of temperature and ventilation; and

- any train that it owns and operates on the freight service meets the levels of safety and general cleanliness required of it in respect of the Domestic Services,

in each case, taking account of the different nature of the intercity passenger service and the freight service (as the case may be) from the Domestic Services.

The Company shall, as soon as reasonably practicable, establish a system with the third party operators for approving the third party trains to run on the railway safely. This shall include the carrying out of design checks and tests, establishing emergency procedures for handling emergencies involving third party trains and not allowing any type of third party train to run in Hong Kong on the railway until the Company has certified in writing to the Secretary that in the opinion of the Company and in the opinion of the Inspector that the Company has carried out the relevant checks and tests and established emergency procedures.

The Company shall use all reasonable endeavours to seek confirmation from the relevant third party operators that arrangements are in place regarding general cleanliness, temperature and ventilation of the third party trains operated on the intercity passenger and freight services that run on the railway.

**Miscellaneous**

***Disclosure of information***

The Government shall not disclose Restricted Information before it consults the Company. Restricted Information is information furnished to the Government, the Secretary, the Commissioner for Transport, the Inspector or any other person acting for or on behalf of the Government by the Company under certain sections of the MTR Ordinance or under the terms of the Operating Agreement, which is specified by the Company to be unpublished commercially sensitive information.

***MTR Ordinance and Rail Merger Ordinance***

The Company is not obliged under the Operating Agreement to conduct its business in any manner or to do anything which is incompatible with any provision of the MTR Ordinance or the Rail Merger Ordinance.

***Law***

The Operating Agreement is governed by Hong Kong law.

## E) MEMORANDUM ON PERFORMANCE REQUIREMENTS

The Memorandum on Performance Requirements was signed by the Company and the Commissioner for Transport for and on behalf of the Government on the Signing Date. It sets out the prescribed formulae for calculating the Performance Requirements.

## F) KSL PROJECT MANAGEMENT AGREEMENT

The KSL Project Management Agreement was entered into on the Signing Date between the Company and KCRC.

### (1) The Services

Pursuant to the terms of the KSL Project Management Agreement, the Company is appointed exclusively:

- to manage the performance of KCRC's principal obligations to the Government in relation to the design and construction of the KSL (other than obligations relating to payment);
- to act as the engineer under the various KSL construction contracts;
- to act as KCRC's representative under the various KSL consultancy agreements; and
- to act as KCRC's agent in connection with the KSL under certain circumstances.

The Company itself will not construct, nor be responsible for the costs of, the KSL works.

The Company agrees to provide the services with all due skill and care and its liability under the KSL Project Management Agreement is limited to circumstances where it is in material breach of the Agreement or in circumstances of willful default or negligence, and is capped at HK$110 million, being the maximum amount which the Company may receive as an incentive payment (as disclosed in the paragraph below).

**(2) Payments**

In return for the performance of the above services, the Company will receive a Project Management Fee of approximately HK$680 million and, if the construction of the KSL is completed ahead of time and equal to or under budget, an incentive payment (calculated with reference to the amount by which the final outturn cost of the project is under budget) of up to HK$110 million.

## G) WEST RAIL AGENCY AGREEMENT

### West Rail Agency Agreement

The West Rail Agency Agreement and related agreements were entered into on the Signing Date between the Company, KCRC, West Rail Property Development Limited ("**WRPDL**", which is and is expected to remain a subsidiary of KCRC) and the West Rail Subsidiaries. The West Rail Agency Agreement sets out the terms and conditions upon which the Company will act as the agent of KCRC and the West Rail Subsidiaries in the development of the thirteen West Rail development sites.

### Appointment of the Company as agent of KCRC and the West Rail Subsidiaries

Pursuant to the terms of the West Rail Agency Agreement, the Company will be appointed:

- to act as KCRC's agent, and donee under powers of attorney, to exercise certain rights and perform certain non-monetary obligations relating to the development sites along West Rail; and

- to act as agent for, and donee under powers of attorney from, each of the West Rail Subsidiaries to exercise certain rights and perform certain non-monetary obligations relating to the development sites along West Rail.

In order to assist the Company in performing its agency functions, KCRC and the West Rail Subsidiaries have granted powers of attorney to the Company. The Company may only use the powers of attorney to exercise rights and perform obligations conferred or undertaken by it under the West Rail Agency Agreement.

Costs incurred by the Company as agent of KCRC under the West Rail Agency Agreement shall be allocated to, and paid by, the West Rail Subsidiaries.

### Awarded Sites

Of the West Rail Subsidiaries, Tuen Mun Property Development Limited, together with any other West Rail Subsidiary which has invited a tender in respect of a West Rail development site prior to the Merger Date and entered into (whether before or after the Merger Date) a development agreement in respect of that tender, are "**Awarded Site Subsidiaries**".

Each Awarded Site Subsidiary shall pay to the Company a fee (the "**Awarded Site Fee**") equal to the aggregate of:

- all costs (including internal costs) or payments incurred or paid by the Company in respect of the Awarded Site Subsidiary, plus 16.5% on-cost, together with interest accrued thereon; and

- 10% of the net amount of profits accrued to the Awarded Site Subsidiary under the development agreement (after, for the avoidance of doubt, taking into account accrued payments which the Awarded Site Subsidiary is obliged to make under the development agreement).

From the Awarded Site Limited Recourse Termination Date, any unpaid Awarded Site Fee shall be due and payable by the relevant Awarded Site Subsidiary in full. The "**Awarded Site Limited Recourse Termination Date**" occurs on the earlier of, *inter alia*:

- the date that WRPDL has received from the West Rail Subsidiaries (including the Awarded Site Subsidiaries) an amount equal to the "**WRPDL Minimum Retained Amount**", being HK$180,000,000 (less an amount of HK$10,000,000 each time a West Rail Subsidiary (other than an Awarded Site Subsidiary) enters into a development agreement);

- the date the Awarded Site Subsidiary pays all amounts due from it to the developer under the development agreement; and

- the date upon which the Awarded Site Subsidiary repays any principal, or pays any interest, in respect of a loan between WRPDL and the Awarded Site Subsidiary (under which WRPDL has onlent monies that WRPDL borrowed from KCRC).

Until (but excluding) the Awarded Site Limited Recourse Termination Date, the Awarded Site Subsidiary shall only be obliged to pay the Awarded Site Fee to the extent it has funds available to do so.

**Unawarded Sites**

***West Rail Subsidiary Related Costs***

Each of the West Rail Subsidiaries (excluding the Awarded Site Subsidiaries) shall pay to the Company the "**West Rail Subsidiary Related Costs**" in respect of that West Rail Subsidiary, which amount shall be all the costs (including internal costs) or payments incurred or paid by the Company in respect of that West Rail Subsidiary, or in respect of KCRC and allocated to that West Rail Subsidiary, plus 16.5% on-cost, together with interest accrued thereon.

From the Related Costs Limited Recourse Termination Date, the West Rail Subsidiary shall be obliged to pay the then outstanding West Rail Subsidiary Related Costs in full on each quarterly payment date. The "**Related Costs Limited Recourse Termination Date**" occurs on the earlier of, *inter alia*:

- the date the West Rail Subsidiary enters into a development agreement; and

- the date upon which the West Rail Subsidiary repays any principal, or pays any interest, in respect of a loan between WRPDL and the West Rail Subsidiary (under which WRPDL has onlent monies that WRPDL borrowed from KCRC).

Until (but excluding) the Related Costs Limited Recourse Termination Date, the West Rail Subsidiary shall only be obliged to pay the West Rail Subsidiary Related Costs to the extent it has funds available to do so.

***Agency fee***

Each West Rail Subsidiary other than Awarded Site Subsidiaries shall pay to the Company an agency fee, which shall be an amount equal to 0.75% of the gross sale proceeds made in respect of its development site.

From the Agency Fee Limited Recourse Termination Date, the West Rail Subsidiary shall be obliged to pay the then outstanding agency fee in full. The "**Agency Fee Limited Recourse Termination Date**" occurs on the earlier of, *inter alia*:

- the date the West Rail Subsidiary receives (under the Consent Scheme) from the relevant stakeholder such amount of gross sale proceeds in respect of its development site which exceed the agency fee then due;
- five Business Days after the date upon which all payment obligations due to the developer under the development agreement for that development site have been satisfied, or the development agreement has been terminated; and
- the date upon which the West Rail Subsidiary repays any principal, or pays any interest, in respect of a loan between WRPDL and the West Rail Subsidiary (under which WRPDL has onlent monies that WRPDL borrowed from KCRC).

Until (but excluding) the Agency Fee Limited Recourse Termination Date, the West Rail Subsidiary shall only be obliged to pay the agency fee to the extent it has funds available to do so.

***Guarantees by developers***

Except for the Awarded Site Subsidiaries, WRPDL and each West Rail Subsidiary shall procure and ensure that each developer (and its relevant guarantor) who enters into a development agreement with the West Rail Subsidiary shall enter into a guarantee which guarantees to the Company the due and punctual performance of all obligations of the relevant West Rail Subsidiary to pay the Company's agency fee.

***Guarantee by WRPDL and the West Rail Subsidiaries***

WRPDL and each West Rail Subsidiary guarantees to the Company the due and punctual performance of all obligations of the West Rail Subsidiaries under the West Rail Agency Agreement.

***WRPDL restrictions on payments***

WRPDL shall not make:

- any payment to KCRC (including payments due under an outstanding loan from KCRC to WRPDL); or
- any dividend or distribution to WRPDL's shareholders,

unless, after making such payments, dividends and distributions, WRPDL would be left with cash in hand or at the bank of at least the WRPDL Minimum Retained Amount.

***Termination***

In respect of each West Rail Subsidiary, the Company shall cease to act as its agent upon the dissolution of that West Rail Subsidiary. The Company shall cease to act as agent of KCRC upon the date it ceases to act as agent for any West Rail Subsidiary.

## H) OUTSOURCING AGREEMENT

The Outsourcing Agreement was entered into on the Signing Date between the Company and KCRC.

After the Merger Date, for a period of two years, KCRC will, pursuant to the terms of the Outsourcing Agreement, outsource certain financial and administrative functions to the Company.

Pursuant to the terms of the Outsourcing Agreement, the Company will:

- provide a number of financial and administrative services to KCRC;
- provide certain staff to enable KCRC to operate after the Rail Merger; and
- receive an annual fee of not more than HK$20 million from KCRC.

The scope of the services to be provided by the Company are set out in a schedule to the Outsourcing Agreement and include services relating to treasury, financial control, information technology, company secretarial, legal and other corporate functions, human resources, office administration and management of claims.

## I) PROPERTY PACKAGE AGREEMENTS

### Category 1A Properties

Under the Sale and Purchase Agreement, KCRC has agreed that on or prior to the Merger Date it shall assign the Category 1A Properties to the KCRC Property Subsidiaries. KCRC has also agreed that all issued shares of those KCRC Property Subsidiaries (which will then own the common areas of the developments and the Category 1A Properties) shall then be transferred on the Merger Date from KCRC to the Company under the Sale and Purchase Agreement.

### Category 1B Properties

On the Signing Date KCRC and the Company entered into an agreement for sale of purchase under which KCRC agreed to assign the Category 1B Properties to the Company on the Merger Date.

### Category 2A Properties

#### *Grant of Government Leases*

On the Signing Date Government entered into an undertaking that it would, within twelve months of the Merger Date or such further period of time as Government and the Company may agree, issue to KCRC an offer for the grant at nil premium of Government Leases in respect of the land upon which the Category 2A Properties are situate. The Category 2A Properties are currently held by KCRC as vested land under the KCRC Ordinance.

On the Signing Date KCRC entered into an undertaking that it would, immediately after the grant of the Government Leases referred to in the above paragraph, enter into an agreement for sale and purchase to sell the Category 2A Properties to the Company. Assignment of the Category 2A Properties to the Company shall then take place pursuant to the agreement for sale and purchase.

#### *Interim arrangements*

The KCRC undertaking also provides that, until such time as KCRC has assigned the Category 2A Properties to the Company, interim arrangements shall be put in place to ensure that, as from the Merger Date, the Company shall be responsible for KCRC's obligations under tenancy agreements or licence agreements relating to the Category 2A Properties, and for enforcing such agreements. The Company shall be entitled to proceeds received by KCRC in respect of those tenancy and licence agreements. The interim arrangements include, *inter alia*, as from the Merger Date:

- KCRC entering into tenancy agreements at market rent with the Company in respect of the Category 2A Properties' vacant units (with the intention that the Company will then sub-let the vacant units to sub-tenants) and entering into licence agreements in respect of the common areas within the Category 2A Properties;

- until the assignment of the Category 2A Properties to the Company, KCRC appointing the Company as its enforcement agent to enforce KCRC's then current Category 2A Properties tenancy agreements against tenants; and

- KCRC assigning to the Company the proceeds received under KCRC's then current Category 2A Properties tenancy agreements with tenants.

**Category 2B Property**

***Grant of Government Lease***

On the Signing Date Government entered into an undertaking that it would, within twenty four months of the Merger Date or such further period of time as Government and the Company may agree, issue to the Company an offer for the grant of a Government Lease of the Category 2B Property on terms to be agreed. The Category 2B Property is currently held by KCRC as vested land under the KCRC Ordinance for use as staff quarters and a recreational club.

***Interim arrangements***

On the Signing Date KCRC entered into an undertaking relating to interim arrangements to ensure that, as from the Merger Date, the Company shall be responsible for KCRC's obligations under licence agreements relating to the Category 2B Property, and for enforcing such agreements. The Company shall be entitled to proceeds received by KCRC in respect of those licence agreements. The interim arrangements include, *inter alia*, as from the Merger Date:

- KCRC granting the Company possession of the Category 2B Property (without payment of any licence fee or premium) as a licensee of KCRC, subject to existing licences and the Second Schedule of the KCRC Ordinance, with the right of the Company to sub-license all or any part of the Category 2B Property (subject to it being used as staff quarters and a recreation club);

- until the grant of the Government Lease of the Category 2B Property, KCRC appointing the Company as its enforcement agent to enforce KCRC's then current Category 2B Property licence agreements against licensees; and

- KCRC assigning to the Company the proceeds received under KCRC's then current Category 2B Property licence agreements with licensees.

**Category 3 Properties**

On the Signing Date the Company entered into three agreements ("**Category 3 Agreements**") and related powers of attorney with KCRC. Each Category 3 Agreement relates to a Category 3 Property. KCRC has previously entered into a development agreement in respect of each Category 3 Property.

***Exclusion of Concession Property***

None of the rights and obligations granted to or undertaken by the Company under the Category 3 Agreements may be exercised or performed by the Company if they relate exclusively to Concession Property situate on any Category 3 Property. Matters affecting the Concession Property situate on any Category 3 Property are dealt with under the terms of the Service Concession Agreement.

***Agency terms***

Pursuant to the terms of each Category 3 Agreement, the Company will be appointed to act as KCRC's agent, and donee under powers of attorney, to exercise rights and to perform obligations of KCRC which relate to the Category 3 Property (but excluding the right or obligation to dispose of the relevant Category 3 Property).

The Company shall at all times comply with statutory restrictions and obligations binding on KCRC which relate to the Category 3 Property, and shall pay all amounts due and payable from KCRC which have been incurred by KCRC as a result of the Company's actions.

In acting as KCRC's agent, the Company shall act according to prudent commercial principles, and aim to maximise gross profits under the Category 3 Property and to run a safe and efficient railway.

In order to assist the Company in performing its agency functions, KCRC has granted powers of attorney to the Company. The Company may only use the powers of attorney to exercise rights and perform obligations conferred or undertaken by it under the relevant Category 3 Agreement.

As well as acting as KCRC's agent, the Company has the right to give KCRC instructions in respect of any action or matter relating to each Category 3 Property (including its related development agreement) which the Company is unable to take by reason of the limitation of the scope of its agency powers. KCRC shall comply promptly with those instructions provided that it is permitted under law, and under the relevant Government grant, to carry out those instructions.

KCRC shall account for revenue received in respect of a Category 3 Property by way of balance sheet movement (rather under its profit and loss account), provided that such treatment is permitted under law and accounting principles and practices.

KCRC shall not take any action in respect of a Category 3 Property which is not carried out by the Company (acting as KCRC's agent), or according to the Company's instructions, or otherwise in accordance with the terms of the Category 3 Agreement.

***Fees***

As consideration for acting as KCRC's agent, the Company shall be paid a fee which is expected to be similar in quantum to the profits made by KCRC in respect of the relevant Category 3 Property (after deducting certain initial and upfront payments and consultant contribution costs, in each case paid or to be paid by the relevant developer to KCRC). Generally, the Company's fee shall be payable in instalments promptly following receipt of relevant funds by KCRC (but subject to specified deductions of amounts due from KCRC to the relevant Category 3 Property developer).

***Indemnities***

The Company shall indemnify KCRC in respect of liability or loss incurred or suffered by KCRC to the extent incurred or suffered as a result of, *inter alia*:

- the Company's actions or omissions in respect of the Category 3 Property (including the Government grant and development agreement); or

- KCRC carrying out any action in accordance with the Company's instructions.

The Company shall also indemnify KCRC for any profits tax liability incurred by KCRC to the extent caused by KCRC being unable to deduct fees payable to the Company under the relevant Category 3 Agreement from the revenue received by KCRC in respect of the Category 3 Property.

KCRC shall indemnify the Company in respect of liability or loss incurred or suffered by the Company to the extent incurred or suffered as a result of KCRC not complying with its obligations under the Category 3 Agreement, or as a result of an agreement relating to the Category 3 Property which KCRC has not disclosed to the Company prior to the Signing Date.

***Other***

The Company shall be the first manager, or shall ensure that a manager is appointed in respect of, each Category 3 Property (once developed).

The Company's appointment as agent shall terminate when KCRC ceases to have any undivided share in the relevant Category 3 Property, other than Concession Property, and neither KCRC nor the developer nor the guarantors have any further rights to exercise, or obligations to perform, under the development agreement relating to the relevant Category 3 Property.

**Category 4 Properties**

On the Signing Date Government entered into an undertaking that it would, within periods to be agreed between MTRC and Government, offer to MTRC a private treaty grant in respect of each Category 4 Property.

The terms of each private treaty grant shall generally be determined by Government, and the premium for each private treaty grant shall be assessed on a full market value basis ignoring the presence of the railway other than the Tin Shui Wai Terminus, Light Rail, Yuen Long, New Territories.

On the Signing Date, the Company issued a letter to KCRC confirming that, if there should be any railway premises on the Category 4 Properties, the Company would assign the railway premises to KCRC.

**Metropolis Equity Sub-participation Agreement**

On the Signing Date, KCRC and the Company entered into an agreement pursuant to which KCRC shall act on the Company's instructions in respect of the exercise of rights KCRC has as a shareholder of The Metropolis Management Company Limited ("**Metropolis**"). KCRC shall not take any action in respect of such rights except as so instructed by the Company. Upon receipt by KCRC of any distribution, or proceeds of sale, relating to its shareholding in Metropolis, KCRC shall promptly pay an amount equal to such received amount to the Company.

The issued share capital of Metropolis is 25,500 A shares (which are held by KCRC) and 24,500 B shares (which are held by Cheung Kong Property Management Limited). Metropolis' business is property management.

The KCRC Subsidiaries (other than V-Connect Limited) also carry out the business of property management. These wholly owned KCRC Subsidiaries shall be transferred to the Company under the terms of the Sale and Purchase Agreement.

**J) LIAISON COMMITTEE LETTER**

The Liaison Committee Letter was issued on the Signing Date by KCRC, the terms of which were acknowledged and agreed to by the Company and the Government.

The Liaison Committee Letter provides that during the period starting from the Signing Date and ending on the day immediately before the Merger Date ("**Interim Period**"), the Liaison Committee shall continue to consist of the same number of members from KCRC, the Company and Government.

The Liaison Committee shall, during the Interim Period, continue to discuss Material Decisions (as defined below) and the financial impact of Material Decisions. The Liaison Committee shall pass to KCRC's managing board any representations made to the Liaison Committee by the Company's members on the Liaison Committee. During the Interim Period, a Material Decision may not be implemented by KCRC without the prior agreement of the Company's members on the Liaison Committee.

A "**Material Decision**" means (i) any decision by KCRC that, if implemented by KCRC, will have material capital or recurrent implications for the Company on and from the Merger Date; or (ii) any decision by KCRC that, under the current practices of KCRC, requires the approval of the managing board of KCRC or one of its sub-committees.

## K) LAND COMFORT LETTER

The Government issued the Land Comfort Letter to KCRC dated 3 August 2007, a copy of which has been received by the Company. Pursuant to the Land Comfort Letter, the Government has agreed that, subject to all necessary approvals being obtained, including those of the Chief Executive in Council, and also subject to the law and land policy prevailing at the time:

(a) the term of years of (i) the private treaty grants (PTGs) for railway sites where KCRC is the sole grantee and the land shall remain in single ownership at the time of the extension of the term of years as hereinafter referred to; and (ii) vesting arrangements (as the case may be) for railway sites which form part of the KCRC Railway and which expire before the expiry of the Concession Period will, within such time as determined by the Government at its sole discretion, be extended to end with the expiry of the Concession Period under the original terms and conditions of the PTGs or vesting arrangements (as the case may be);

(b) in relation to other types of land interests, the Government will take such steps and render such assistance to KCRC as considered appropriate, reasonable and practicable at the time, to facilitate the smooth operation of the railway during the Concession Period; and

(c) if the Concession Period is extended in future, the Government will within such time as determined by the Government at its sole discretion:

    (A) extend the term of the land interests referred to in paragraph (a) above to make the term coterminous with the extended service concession period, provided that there has been no change in ownership of the said land interests since the Merger Date; and

    (B) take such steps and render such assistance to KCRC as considered appropriate, reasonable and practicable at the time, to facilitate the smooth operation of the KCRC Railway during the Concession Period. The Chief Executive in Council's advice will also be sought where appropriate.

## L) KCRC CROSS BORDER LEASE AGREEMENTS

The following description of the KCRC CBL agreements is based upon publicly available information set out in KCRC's 2006 Annual Report or 2006 Form 20-F, and information provided to the Company by KCRC.

The property and equipment intended to be subject to the Service Concession Agreement includes property and equipment (the "**CBL Property**") that is subject to 18 separate cross border lease transactions that were entered into by KCRC, certain of KCRC's subsidiary companies, various U.S. institutional investors and certain other parties between 1998 and 2003 (the "**CBLs**"). The CBL Property includes rolling stock, signalling equipment, revenue collection equipment and railway infrastructure.

In each CBL, the relevant CBL Property has been leased to a U.S. trust (in each case, a "**Trust**") established for the benefit of the relevant U.S. institutional investor for a fixed long term period pursuant to a "**Head Lease Agreement**", and all rentals due in connection therewith have been prepaid by such Trust (the "**Lump Sum Payment**"). The aggregate amount of all Lump Sum Payments for all CBLs was equal to approximately US$1,383 million as at the closings of the respective CBLs.

Simultaneously with the entering into of such Head Lease Agreements, the respective Trusts leased the relevant CBL Property back to a KCRC subsidiary (in each case, a "**Lessee**") pursuant to separate "**Lease Agreements**", and such Lessees subleased such CBL property to KCRC pursuant to separate "**Sublease Agreements**". The tenors of the Lease Agreements and the Sublease Agreements, which depending on the terms of the respective CBLs are scheduled to expire between 2015 and 2031 (in any such case, the "**CBL Scheduled Expiration Date**"), are in each case shorter than the tenors of the corresponding Head Lease Agreements.

Under the respective Lease Agreements, the Lessees (i) have agreed to (a) pay periodic US$ denominated rentals on a semi-annual or annual basis in accordance with pre-determined payment schedules, (b) use, maintain, operate and insure the CBL Property according to agreed standards or procure the same from KCRC (as sublessee) and (c) pay certain US$ denominated termination amounts if the relevant Lease Agreement terminates prior to its CBL Scheduled Expiration Date (the "**TV Amounts**"), whether as a result of an event of default in respect of which a Trust exercises a remedy to receive money damages, the occurrence of an event of loss or otherwise; and (ii) have the right to acquire the interests of the respective Trusts in the CBLs as at the relevant CBL Scheduled Expiration Date pursuant to a US$ denominated fixed price purchase option (each, an "**FPO**"), as well as upon the occurrence of other events prior to the relevant CBL Scheduled Expiration Date. If an FPO is not exercised in any CBL, the Lessee in respect thereof will be required to return the relevant CBL Property to the related Trust and take certain other actions in connection with the then intended use thereof.

As at or shortly after the closing of the respective CBLs, portions of the Lump Sum Payments received from the respective Trusts were placed in deposit arrangements and/or invested in debt securities (collectively, the "**Investments**"). The scheduled repayments on the Investments are expected to be sufficient to meet the Lessees' respective periodic rental obligations under the Leases and amounts payable in connection with the FPOs.

The proceeds of the Investments are also intended to be available to meet the obligations of the Lessees in the event of an early termination under the CBLs which results in the TV Amounts becoming payable. As at 31 December 2006, the aggregate TV Amounts under all Lease Agreements were equal to approximately US$1,720 million, and the Investments had a value equal to approximately US$1,499 million, understanding that (i) the TV Amounts will vary over time according to the terms of the CBLs and (ii) the value of the Investments will also vary over time based on, *inter alia*, periodic changes in interest rates.

Under other agreements relating to the CBLs, KCRC has agreed to guarantee all CBL obligations of the respective Lessees, and KCRC and such Lessees have provided various representations, warranties, covenants and agreements for the benefit of the other CBL parties, including with respect to (i) the provision of certain tax and other indemnities and (ii) agreements relating to mergers, consolidations, asset transfers and other similar matters relating to KCRC and such Lessees. Breaches of such representations, warranties, covenants and agreements will, subject to certain grace and cure provisions, give rise to an event of default under the relevant CBL. If an event of default occurs, the respective Trusts will have a variety of contractual remedies, including the right to demand payment of the relevant TV Amounts and the right to seek repossession of the relevant CBL Property.

**US CBL Assumption Agreements**

Separate US CBL Assumption Agreements are expected to be entered into with respect to each CBL on or prior to the Merger Date.

Pursuant to each US CBL Assumption Agreement, the Company will undertake to perform, on a joint and several basis with KCRC, the obligations of KCRC under the respective CBLs. As a result thereof, the Company will generally become liable to the CBL counterparties in respect of KCRC's obligations under the CBLs and have the right to exercise certain of KCRC's rights under the CBLs.

### US CBL Allocation Agreement

The US CBL Allocation Agreement is expected to be entered into on or before the date that the Company enters into a US CBL Assumption Agreement. Pursuant to the US CBL Allocation Agreement, rights, obligations and responsibility for risks relating to the CBLs will be delineated and allocated between KCRC and the Company (each of which will be jointly and severally liable to specified CBL counterparties, as referred to in the section above headed "US CBL Assumption Agreements").

It is intended that, as between the Company and KCRC, (i) the Company will be responsible for the "**MTRC Obligations**" and certain "**Common Obligations**", which generally include, amongst other things, (a) operational obligations relating to the Concession Property which is subject to the CBLs (such as maintenance, insurance, repair and various related items) and (b) certain general financing covenants made for the benefit of the CBL parties (such as restrictions on mergers, asset sales and similar transactions, as well as affirmative obligations relating to, amongst other things, the maintenance of all required governmental consents); and (ii) KCRC will be responsible for all other obligations of KCRC and certain KCRC subsidiaries relating to the CBLs (including, in particular, collateral related obligations and general financing covenants applicable to KCRC).

The Company and KCRC will each make representations under the US CBL Allocation Agreement, which will include, in the case of those to be made by KCRC, representations with respect to the status of the CBLs.

The Company and KCRC will each agree to indemnify each other for losses (and for reasonable costs incurred) arising from (i) any breach of their respective covenants and agreements under the US CBL Allocation Agreement, or (ii) any of their respective representations in the US CBL Allocation Agreement being inaccurate, in each case subject to certain exclusions (which exclusions include matters such as the fraud, negligence or bad faith of the other party and/or the failure of the other party to perform certain covenants).

### Provisions contained in the Merger Framework Agreement

The Merger Framework Agreement includes provisions relating specifically to the CBLs. A description of those provisions is set out above under the paragraph headed "KCRC's Cross Border Leases" in the section of this Appendix headed "The Merger Framework Agreement".

The following consolidated profit and loss account, consolidated statements of changes in equity and consolidated cash flow statements of MTR Corporation Limited (the "Company") (together with its subsidiaries are referred to as the "Group") for each of the three years ended 31 December 2006 and for the six month periods ended 30 June 2006 and 2007, and the consolidated balance sheets as at 31 December 2004, 2005 and 2006, and as at 30 June 2006 and 2007, are reproduced from the published audited accounts of the Group for the three years then ended and from the unaudited interim accounts of the Group for the six month periods ended 30 June 2006 and 2007 respectively. The consolidated profit and loss account, consolidated statement of changes in equity, consolidated cash flow statements and consolidated balance sheets are prepared in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA").

## A. CONSOLIDATED PROFIT AND LOSS ACCOUNT

*in HK$ million*

| | NOTE | Year ended 31 December 2006 | 2005 | 2004 | Six months ended 30 June 2007 (unaudited) | 2006 (unaudited) |
|---|---|---|---|---|---|---|
| Fare revenue | 3 | 6,523 | 6,282 | 5,932 | 3,247 | 3,138 |
| Station commercial and rail related revenue | 4A | 1,542 | 1,555 | 1,311 | 735 | 735 |
| Rental, management and other income | 4B | 1,476 | 1,316 | 1,108 | 870 | 693 |
| **Turnover** | | 9,541 | 9,153 | 8,351 | 4,852 | 4,566 |
| Staff costs and related expenses | 5A | (1,653) | (1,614) | (1,546) | (784) | (777) |
| Energy and utilities | | (539) | (541) | (544) | (251) | (249) |
| Operational rent and rates | | (65) | (92) | (70) | (45) | (26) |
| Stores and spares consumed | | (120) | (120) | (128) | (53) | (52) |
| Repairs and maintenance | 5B | (511) | (496) | (517) | (233) | (235) |
| Railway support services | | (80) | (74) | (72) | (42) | (39) |
| Expenses relating to station commercial and rail related businesses | | (410) | (358) | (315) | (165) | (183) |
| Expenses relating to property ownership, management and other expenses | | (345) | (238) | (207) | (223) | (132) |
| Project study and business development expenses | 5C | (267) | (142) | (167) | (112) | (84) |
| General and administration expenses | 5D | (192) | (207) | (167) | (67) | (82) |
| Other expenses | 5D | (158) | (170) | (89) | (80) | (68) |
| **Operating expenses before depreciation** | | (4,340) | (4,052) | (3,822) | (2,055) | (1,927) |
| **Operating profit from railway and related businesses before depreciation** | | 5,201 | 5,101 | 4,529 | 2,797 | 2,639 |
| Profit on property developments | 7 | 5,817 | 6,145 | 4,568 | 1,664 | 4,072 |
| **Operating profit before depreciation** | | 11,018 | 11,246 | 9,097 | 4,461 | 6,711 |
| Depreciation | 8 | (2,674) | (2,682) | (2,499) | (1,348) | (1,315) |
| **Operating profit before interest and finance charges** | | 8,344 | 8,564 | 6,598 | 3,113 | 5,396 |
| Interest and finance charges | 9 | (1,398) | (1,361) | (1,450) | (654) | (739) |
| Change in fair value of investment properties | 16 | 2,178 | 2,800 | 2,486 | 2,450 | 1,478 |
| Share of profits less losses of non-controlled subsidiaries and associates | 10 | 45 | 9 | 39 | 42 | 16 |
| **Profit before taxation** | | 9,169 | 10,012 | 7,673 | 4,951 | 6,151 |
| Income tax | 11A | (1,411) | (1,549) | (1,130) | (879) | (984) |
| **Profit for the year/period** | | 7,758 | 8,463 | 6,543 | 4,072 | 5,167 |
| **Attributable to:** | | | | | | |
| — Equity shareholders of the Company | 12 | 7,759 | 8,450 | 6,543 | 4,071 | 5,167 |
| — Minority interests | | (1) | 13 | — | 1 | — |
| **Profit for the year/period** | | 7,758 | 8,463 | 6,543 | 4,072 | 5,167 |
| **Dividends paid and proposed to equity shareholders of the Company attributable to the year/period:** | 13 | | | | | |
| — Interim dividend declared and paid during the year/period | | 774 | 764 | 750 | 782 | 774 |
| — Final dividend proposed after the balance sheet date | | 1,554 | 1,535 | 1,509 | — | — |
| | | 2,328 | 2,299 | 2,259 | 782 | 774 |
| **Earnings per share:** | 14 | | | | | |
| — Basic | | HK$1.41 | HK$1.55 | HK$1.23 | HK$0.73 | HK$0.94 |
| — Diluted | | HK$1.41 | HK$1.55 | HK$1.23 | HK$0.73 | HK$0.94 |

## B. (1) CONSOLIDATED BALANCE SHEET

*in HK$ million*

| | NOTE | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 (unaudited) | At 30 June 2006 (unaudited) |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Fixed assets | 16 | | | | | |
| — Investment properties | | 22,539 | 19,892 | 16,687 | 25,013 | 21,377 |
| — Other property, plant and equipment | | 84,404 | 83,383 | 83,005 | 83,812 | 83,550 |
| | | 106,943 | 103,275 | 99,692 | 108,825 | 104,927 |
| Railway construction in progress | 17 | 232 | 1,006 | 962 | 276 | 1,185 |
| Property development in progress | 18A | 3,297 | 2,756 | 2,088 | 3,200 | 3,189 |
| Deferred expenditure | 19 | 565 | 281 | 243 | 743 | 420 |
| Prepaid land lease payments | 20 | 594 | 608 | 621 | 587 | 601 |
| Interests in non-controlled subsidiaries | 21 | 171 | 103 | 63 | 213 | 131 |
| Interests in associates | 23 | 100 | — | — | 203 | 100 |
| Deferred tax assets | 38B | 1 | 19 | 15 | 1 | 19 |
| Investments in securities | 24 | 272 | 183 | 202 | 340 | 205 |
| Staff housing loans | 25 | 25 | 34 | 47 | 18 | 29 |
| Properties held for sale | 26 | 2,018 | 1,311 | 815 | 2,164 | 3,364 |
| Derivative financial assets | 27 | 195 | 234 | — | 192 | 113 |
| Stores and spares | 28 | 272 | 248 | 248 | 277 | 261 |
| Debtors, deposits and payments in advance | 29 | 1,894 | 3,095 | 1,276 | 1,957 | 3,967 |
| Loan to a property developer | 30 | 3,355 | — | — | 3,442 | 3,268 |
| Amounts due from the Government and other related parties | 31 | 177 | 154 | 133 | 183 | 170 |
| Cash and cash equivalents | 32 | 310 | 359 | 269 | 413 | 369 |
| | | 120,421 | 113,666 | 106,674 | 123,034 | 122,318 |
| **Liabilities** | | | | | | |
| Bank overdrafts | 33A | 5 | 14 | 11 | 1 | 12 |
| Short-term loans | 33A | 1,114 | 385 | — | 24 | 1,013 |
| Creditors, accrued charges and provisions | 34 | 3,639 | 3,415 | 3,146 | 5,525 | 3,700 |
| Current taxation | 38A | 1 | 2 | 3 | 1 | 1 |
| Contract retentions | 35 | 193 | 170 | 240 | 160 | 171 |
| Amounts due to related parties | 36 | — | 17 | 1 | — | 2 |
| Loans and obligations under finance leases | 33A | 27,033 | 27,865 | 30,367 | 25,145 | 30,784 |
| Derivative financial liabilities | 27 | 515 | 307 | — | 281 | 443 |
| Deferred income | 37 | 1,682 | 3,584 | 4,638 | 1,226 | 2,580 |
| Deferred tax liabilities | 38B | 9,453 | 8,011 | 6,368 | 10,374 | 9,044 |
| | | 43,635 | 43,770 | 44,774 | 42,737 | 47,750 |
| **Net assets** | | 76,786 | 69,896 | 61,900 | 80,297 | 74,568 |
| **Capital and reserves** | | | | | | |
| Share capital, share premium and capital reserve | 39A | 38,639 | 37,450 | 36,269 | 39,421 | 38,248 |
| Other reserves | 40 | 38,128 | 32,425 | 25,623 | 40,856 | 36,299 |
| **Total equity attributable to equity shareholders of the Company** | | 76,767 | 69,875 | 61,892 | 80,277 | 74,547 |
| **Minority interests** | | 19 | 21 | 8 | 20 | 21 |
| **Total equity** | | 76,786 | 69,896 | 61,900 | 80,297 | 74,568 |

## B. (2) BALANCE SHEET OF THE COMPANY

*in HK$ million*

| | NOTE | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 (unaudited) | At 30 June 2006 (unaudited) |
|---|---|---|---|---|---|---|
| **Assets** | | | | | | |
| Fixed assets | 16 | | | | | |
| — Investment properties | | 22,539 | 19,892 | 16,687 | 25,013 | 21,377 |
| — Other property, plant and equipment | | 84,256 | 83,286 | 82,845 | 83,654 | 83,458 |
| | | 106,795 | 103,178 | 99,532 | 108,667 | 104,835 |
| Railway construction in progress | 17 | 232 | 1,006 | 962 | 276 | 1,185 |
| Property development in progress | 18A | 3,297 | 2,756 | 2,088 | 3,200 | 3,189 |
| Deferred expenditure | 19 | 283 | 115 | 192 | 343 | 182 |
| Prepaid land lease payments | 20 | 594 | 608 | 621 | 587 | 601 |
| Investments in subsidiaries | 22 | 184 | 182 | 182 | 184 | 182 |
| Staff housing loans | 25 | 25 | 34 | 47 | 18 | 29 |
| Properties held for sale | 26 | 2,018 | 1,311 | 815 | 2,164 | 3,364 |
| Derivative financial assets | 27 | 195 | 234 | — | 192 | 113 |
| Stores and spares | 28 | 272 | 248 | 248 | 275 | 261 |
| Debtors, deposits and payments in advance | 29 | 1,782 | 2,975 | 1,271 | 1,866 | 3,879 |
| Loan to a property developer | 30 | 3,355 | — | — | 3,442 | 3,268 |
| Amounts due from the Government and other related parties | 31 | 700 | 424 | 275 | 931 | 688 |
| Cash and cash equivalents | 32 | 127 | 116 | 137 | 207 | 69 |
| | | 119,859 | 113,187 | 106,370 | 122,352 | 121,845 |
| **Liabilities** | | | | | | |
| Bank overdrafts | 33A | 5 | 14 | 11 | 1 | 12 |
| Short-term loans | 33A | 1,114 | 385 | — | — | 1,013 |
| Creditors, accrued charges and provisions | 34 | 3,259 | 3,086 | 2,867 | 5,183 | 3,435 |
| Current taxation | 38A | — | — | — | 1 | — |
| Contract retentions | 35 | 191 | 170 | 240 | 152 | 169 |
| Amounts due to related parties | 36 | 11,718 | 12,773 | 12,871 | 11,687 | 11,061 |
| Loans and obligations under finance leases | 33A | 15,518 | 15,290 | 17,701 | 13,614 | 19,885 |
| Derivative financial liabilities | 27 | 515 | 307 | — | 281 | 443 |
| Deferred income | 37 | 1,682 | 3,584 | 4,638 | 1,226 | 2,580 |
| Deferred tax liabilities | 38B | 9,453 | 8,011 | 6,368 | 10,374 | 9,044 |
| | | 43,455 | 43,620 | 44,696 | 42,519 | 47,642 |
| **Net assets** | | 76,404 | 69,567 | 61,674 | 79,833 | 74,203 |
| **Capital and reserves** | | | | | | |
| Share capital, share premium and capital reserve | 39A | 38,639 | 37,450 | 36,269 | 39,421 | 38,248 |
| Other reserves | 40 | 37,765 | 32,117 | 25,405 | 40,412 | 35,955 |
| **Total equity** | | 76,404 | 69,567 | 61,674 | 79,833 | 74,203 |

## C. CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY

*in HK$ million*

| | NOTE | Year ended 31 December 2006 | Year ended 31 December 2005 | Year ended 31 December 2004 | Six months ended 30 June 2007 (unaudited) | Six months ended 30 June 2006 (unaudited) |
|---|---|---|---|---|---|---|
| Total equity as at 1 January as previously reported | | | | | | |
| — Attributable to equity shareholders of the Company | | 69,875 | 61,892 | 56,123 | 76,767 | 69,875 |
| — Minority interests | | 21 | 8 | 8 | 19 | 21 |
| | | 69,896 | 61,900 | 56,131 | 76,786 | 69,896 |
| Effect of prospective adoption of new accounting policy with respect to financial instruments | | — | 124 | — | — | — |
| **Total equity as at 1 January** | | 69,896 | 62,024 | 56,131 | 76,786 | 69,896 |
| Cash flow hedges: | 40 | | | | | |
| Effective portion of changes in fair value, net of deferred tax | | (18) | 69 | — | 81 | 6 |
| Transfer from equity | | | | | | |
| — to profit and loss account | | (17) | 32 | — | — | (11) |
| — to initial carrying amount of non-financial hedged items | | (2) | (21) | — | — | (2) |
| — to deferred tax | | 3 | 10 | — | — | 2 |
| | | (34) | 90 | — | 81 | (5) |
| Surplus on revaluation of self-occupied land and buildings, net of deferred tax | 40 | 271 | 406 | 273 | 120 | 242 |
| Exchange difference on translation of accounts of overseas subsidiaries | 40 | 13 | 4 | — | 10 | 3 |
| Net income recognised directly in equity | | 250 | 500 | 273 | 211 | 240 |
| Net profit for the year/period | | 7,758 | 8,463 | 6,543 | 4,072 | 5,167 |
| **Total recognised income and expense for the year/period** | | 8,008 | 8,963 | 6,816 | 4,283 | 5,407 |
| **Dividends declared or approved during the year/period** | 13 | | | | | |
| — Final dividend | | (1,535) | (1,509) | (1,481) | (1,554) | (1,535) |
| — Interim dividend | | (774) | (764) | (750) | — | — |
| | | (2,309) | (2,273) | (2,231) | (1,554) | (1,535) |
| Shares issued during the year/period | 39A | | | | | |
| — Employee Share Option Scheme | | 36 | 46 | 68 | 6 | 31 |
| — Scrip Dividend Scheme | | 1,153 | 1,135 | 1,115 | 776 | 767 |
| | | 1,189 | 1,181 | 1,183 | 782 | 798 |
| Employee share-based payments | 40 | 3 | 1 | 1 | — | 2 |
| **Movements in equity arising from capital transactions** | | 1,192 | 1,182 | 1,184 | 782 | 800 |
| **Reduction in minority interests on disposal of a subsidiary** | | (1) | — | — | — | — |
| **Total equity as at 31 December/30 June** | | 76,786 | 69,896 | 61,900 | 80,297 | 74,568 |
| **Total recognised income and expense for the year/period attributable to:** | | | | | | |
| — Equity shareholders of the Company | | 8,009 | 8,950 | 6,816 | 4,282 | 5,407 |
| — Minority interests | | (1) | 13 | — | 1 | — |
| | | 8,008 | 8,963 | 6,816 | 4,283 | 5,407 |

## D. CONSOLIDATED CASH FLOW STATEMENTS

*in HK$ million*

| | | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|---|
| | *NOTE* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| **Cash flows from operating activities** | | | | | | |
| Operating profit from railway and related businesses before depreciation | | 5,201 | 5,101 | 4,529 | 2,797 | 2,639 |
| Adjustments for: | | | | | | |
| Decrease in provision for obsolete stock | | (2) | — | (3) | (2) | (5) |
| Loss on disposal of fixed assets | | 37 | 40 | 19 | 14 | 15 |
| Write-back of revaluation deficit of self-occupied land and buildings | | — | — | (69) | — | — |
| Deferred project study costs written off | | 26 | — | 64 | — | — |
| Amortisation of deferred income from lease transaction | | (6) | (6) | (5) | (2) | (3) |
| Amortisation of prepaid land lease payments | | 14 | 13 | 13 | 7 | 7 |
| (Increase)/decrease in fair value of derivative instruments | | (7) | 9 | — | 1 | (8) |
| Unrealised (gain)/loss on revaluation of investment in securities | | (2) | — | — | 1 | — |
| Employee share-based payment expenses | | 9 | 5 | 4 | 2 | 5 |
| Exchange (gain)/loss | | (1) | (7) | 3 | — | 6 |
| Operating profit from railway and related businesses before working capital changes | | 5,269 | 5,155 | 4,555 | 2,818 | 2,656 |
| (Increase)/decrease in debtors, deposits and payments in advance | | (53) | (82) | (198) | 70 | 17 |
| (Increase)/decrease in stores and spares | | (17) | — | 3 | (3) | (8) |
| Increase in creditors, accrued charges and provisions | | 191 | 117 | 148 | 97 | 65 |
| Cash generated from operations | | 5,390 | 5,190 | 4,508 | 2,982 | 2,730 |
| Overseas tax paid | | (3) | (2) | (3) | (1) | (2) |
| **Net cash generated from operating activities** | | 5,387 | 5,188 | 4,505 | 2,981 | 2,728 |
| **Cash flows from investing activities** | | | | | | |
| Capital expenditure | | | | | | |
| — Tseung Kwan O Extension Project | | (6) | (114) | (94) | (6) | (5) |
| — Tseung Kwan O South Station Project | | (109) | (27) | (13) | (104) | (27) |
| — Disneyland Resort Line Project | | (45) | (272) | (622) | (9) | (28) |
| — Tung Chung Cable Car Project | | (165) | (413) | (345) | (10) | (157) |

| | NOTE | Year ended 31 December 2006 | 2005 | 2004 | Six months ended 30 June 2007 (unaudited) | 2006 (unaudited) |
|---|---|---|---|---|---|---|
| — Tseung Kwan O property development projects | | (134) | (1,207) | (45) | (67) | (69) |
| — Property fitting out works and other development projects | | (815) | (227) | (138) | (209) | (273) |
| — Purchase of assets and other capital projects | | (1,629) | (1,194) | (1,632) | (657) | (780) |
| Merger studies | | (88) | (17) | (53) | (50) | (25) |
| Receipts in respect of property development | | 4,400 | 2,610 | 2,576 | 3,136 | 584 |
| Loan to a property developer | | (4,000) | — | — | — | (4,000) |
| Purchase of investment in securities | | (194) | (114) | (202) | (151) | (104) |
| Proceeds from sale of investment in securities | | 106 | 133 | — | 82 | 81 |
| Loans to associates | | — | (15) | — | — | — |
| Investment in an associate | | (100) | — | — | (103) | (100) |
| Principal repayments under Staff Housing Loan Scheme | | 9 | 13 | 21 | 7 | 5 |
| **Net cash (used in)/generated from investing activities** | | (2,770) | (844) | (547) | 1,859 | (4,898) |
| **Cash flows from financing activities** | | | | | | |
| Proceeds from shares issued | | 36 | 46 | 68 | 6 | 31 |
| Drawdown of loans | | 6,929 | 3,800 | 2,085 | 924 | 6,228 |
| Proceeds from issuance of capital market instruments | | 1,499 | 1,491 | 5,109 | — | 499 |
| Repayment of loans | | (5,749) | (2,721) | (4,372) | (4,031) | (903) |
| Repayment of capital market instruments | | (2,450) | (4,168) | (4,415) | — | (2,000) |
| Reduction in capital element of finance lease | | (131) | (121) | (112) | (69) | (64) |
| Interest paid | | (1,611) | (1,416) | (1,301) | (791) | (830) |
| Interest received | | 10 | 16 | 7 | 15 | 6 |
| Interest element of finance lease rental payments | | (19) | (29) | (38) | (6) | (11) |
| Finance charges paid | | (16) | (17) | (16) | (4) | (7) |
| Dividends paid | | (1,155) | (1,138) | (1,079) | (777) | (767) |
| **Net cash (used in)/generated from financing activities** | | (2,657) | (4,257) | (4,064) | (4,733) | 2,182 |
| Net (decrease)/increase in cash and cash equivalents | | (40) | 87 | (106) | 107 | 12 |
| Cash and cash equivalents at 1 January | | 345 | 258 | 364 | 305 | 345 |
| Cash and cash equivalents at 31 December/30 June | 32 | 305 | 345 | 258 | 412 | 357 |

## E. NOTES TO THE CONSOLIDATED ACCOUNTS

### 1 Statement of compliance

These accounts have been prepared in compliance with the Hong Kong Companies Ordinance and the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules"). These accounts have also been prepared in accordance with all applicable Hong Kong Financial Reporting Standards ("HKFRSs"), which collective term includes all applicable individual Hong Kong Financial Reporting Standards, Hong Kong Accounting Standards ("HKAS") and Interpretations issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), and accounting principles generally accepted in Hong Kong. A summary of the principal accounting policies adopted by the Group is set out in note 2.

The HKICPA has issued certain new and revised HKFRSs that are effective for accounting periods beginning on or after 1 January 2007. Changes in accounting policies resulting from initial application of these developments to the extent that they are relevant to the Group for the current and prior accounting periods reflected in these accounts are disclosed in note 2A(iii).

### 2 Principal accounting policies

#### *A Basis of preparation of the accounts*

i The measurement basis used in the preparation of the accounts is historical cost basis except that the following assets and liabilities are stated at their fair value as explained in the accounting policies set out below:

— investment properties (see note 2F(i));

— other leasehold land and buildings, for which the fair values cannot be measured separately at the inception of the lease and the entire lease is classified as a finance lease (see note 2F(ii));

— financial instruments classified as investments in securities (see note 2L); and

— derivative financial instruments (see note 2T).

ii The preparation of the accounts in conformity with HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets, liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the circumstances, the results of which form the basis of making the judgements and estimations about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements made by management in the application of HKFRSs that have significant effect on the accounts and estimates are discussed in note 48.

iii The HKICPA has issued certain new and revised HKFRSs that are effective for accounting periods beginning on or after 1 January 2007. Among those new and revised standards, HKFRS 7 "Financial Instruments: Disclosure" and Amendment to HKAS 1 "Presentation of Financial Statements — Capital Disclosures" have been adopted by the Company. However, the adoption of these accounting standards has no impact on the Group's results of operations.

***B Basis of consolidation***

The consolidated accounts include the accounts of the Group and the Group's interest in non-controlled subsidiaries (see note 2D) and associates made up to each balance sheet date. The results of subsidiaries acquired or disposed of during the reporting periods are included in the consolidated profit and loss account from or to the date of their acquisition or disposal, as appropriate.

***C Subsidiaries***

A subsidiary in accordance with the Hong Kong Companies Ordinance is a company in which the Group, directly or indirectly, holds more than half of the issued share capital, or controls more than half of the voting power, or controls the composition of the board of directors. Subsidiaries are considered to be controlled if the Company has the power, directly or indirectly, to govern the financial and operating policies, so as to obtain benefits from their activities.

Intra-group balances and transactions, and any unrealised profits arising from intra-group transactions, are eliminated in full in preparing the consolidated accounts. Unrealised losses resulting from intra-group transactions are eliminated in the same way as unrealised gains, but only to the extent that there is no evidence of impairment.

Minority interests at the balance sheet date, being the portion of the net assets of subsidiaries attributable to equity interests that are not owned by the Company, whether directly or indirectly through subsidiaries, are presented in the consolidated balance sheet and statement of changes in equity within equity, separately from equity attributable to the equity shareholders of the Company. Minority interests in the results of the Group are presented on the face of the consolidated profit and loss account as an allocation of the total profit or loss for the period between minority interests and the equity shareholders of the Company.

Where losses attributable to the minority exceed the minority interest in the equity of a subsidiary, the excess, and any further losses attributable to the minority, are charged against the Group's interest except to the extent that the minority has a binding obligation to, and is able to, make good the losses. All subsequent profits of the subsidiary are allocated to the Group until the minority's share of losses previously absorbed by the Group has been recovered.

Investments in subsidiaries are carried in the Company's balance sheet at cost less any impairment losses (see note 2G(ii)).

***D Non-controlled subsidiaries***

Non-controlled subsidiaries are not consolidated in the accounts as the Group does not have effective control over their Boards. The investments in non-controlled subsidiaries are accounted for in the consolidated accounts of the Company using the equity method and are initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of their net assets. The consolidated profit and loss account reflects the Group's share of the results of those non-controlled subsidiaries for the period.

Unrealised profits and losses resulting from transactions between the Group and the non-controlled subsidiaries are eliminated to the extent of the Group's interest in those subsidiaries, except where unrealised losses provide evidence of an impairment of the asset transferred, in which case they are recognised immediately in the profit and loss account.

In the Company's balance sheet, its investments in non-controlled subsidiaries are stated at cost less impairment losses (see note 2G(ii)).

***E Associates and jointly controlled entities***

An associate is an entity over which the Group or the Company has significant influence, but not control or joint control, over its management, including participation in the financial and operating policy decisions.

A jointly controlled entity is an entity which operates under a contractual arrangement between the Group or the Company and other parties, where the contractual arrangement establishes that the Group or the Company and one or more of the other parties share joint control over the economic activity of the entity.

An investment in an associate or a jointly controlled entity is accounted for in the consolidated accounts of the Company using the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the associate's or the jointly controlled entity's net assets. The consolidated profit and loss account reflects the Group's share of the post acquisition results of the associates and jointly controlled entities for the period.

When the Group's share of losses equals or exceeds its interest in the associate or the jointly controlled entity, the Group's interest is reduced to nil and recognition of further losses is discontinued except to the extent that the Group has incurred legal or constructive obligations or made payments on behalf of the associate or the jointly controlled entity. For this purpose, the Group's interest in the associate and the jointly controlled entity is the carrying amount of the investment under the equity method together with the Group's long-term interests that in substance form part of the Group's net investment in the associate or the jointly controlled entity.

Unrealised profits and losses resulting from transactions between the Group and its associates and jointly controlled entities are eliminated to the extent of the Group's interest in the associates and jointly controlled entities, except where unrealised losses provide evidence of an impairment of the asset transferred, in which case they are recognised immediately in the profit and loss account.

In the Company's balance sheet, its investments in associates and jointly controlled entities are stated at cost less impairment losses (see note 2G(ii)).

***F Fixed assets***

i Investment properties are land and/or buildings which are owned or held under a leasehold interest to earn rental income and/or for capital appreciation.

Investment properties are stated in the balance sheet at fair value as determined at least annually by independent professionally qualified valuers. Gains or losses arising from changes in the fair value are recognised as profit or loss in the period in which they arise.

Property that is being constructed or developed for future use as investment property is classified as asset under construction within property, plant and equipment and stated at cost until construction or development is complete, at which time it is reclassified as investment property at fair value. Any difference between the fair value of the property at that date and its previous carrying amount is recognised in the profit and loss account.

ii Land held for own use under operating leases and buildings thereon, where the fair values of the leasehold interest in the land and buildings cannot be measured separately at the inception of the lease are accounted for as being held under a finance lease, unless the buildings are also clearly held under an operating lease. The self-occupied land and buildings are stated in the balance sheet at their fair values on the basis of their existing use at the date of revaluation less any subsequent accumulated depreciation. Revaluations are performed by independent qualified valuers, with changes in the value arising on revaluations treated as movements in the fixed asset revaluation reserve, except:

— where the balance of the fixed asset revaluation reserve relating to a self-occupied land and building is insufficient to cover a revaluation deficit of that property, the excess of the deficit is charged to the profit and loss account; and

— where a revaluation deficit had previously been charged to the profit and loss account and a revaluation surplus subsequently arises, this surplus is firstly credited to the profit and loss account to the extent of the deficit previously charged to the profit and loss account, and is thereafter taken to the fixed asset revaluation reserve.

iii Civil works and plant and equipment are stated at cost less accumulated depreciation and impairment losses (see note 2G(ii)).

iv Assets under construction are stated at cost less impairment losses (see note 2G(ii)). Cost comprises direct costs of construction, such as materials, staff costs and overheads, together with interest expense capitalised during the period of construction or installation and testing. Capitalisation of these costs ceases and the asset concerned is transferred to the appropriate fixed assets category when substantially all the activities necessary to prepare the asset for its intended use are completed.

v *Leased assets*

(a) Leases of assets under which the lessee assumes substantially all the risks and rewards of ownership are classified as finance leases. Where the Group acquires the use of assets under finance leases, the amounts representing the fair value of the leased asset, or, if lower, the present value of the minimum lease payments (computed using the rate of interest implicit in the lease), of such assets are included in fixed assets and the corresponding liabilities, net of finance charges, are recorded as obligations under finance leases. Depreciation and impairment losses are accounted for in accordance with the accounting policy as set out in notes 2H(iv) and 2G(ii) respectively. Finance charges implicit in the lease payments are charged to the profit and loss account over the period of the leases so as to produce an approximately constant periodic rate of charge on the remaining balance of the obligations for each accounting period.

(b) Leases of assets, other than that mentioned in note 2F(v)(c) below, under which the lessor has not transferred substantially all the risks and rewards of ownership are classified as operating leases. Where the Group leases out assets under operating leases, the assets are included in the balance sheet according to their nature and, where applicable, are depreciated in accordance with the Group's depreciation policies. Impairment losses are accounted for in accordance with the accounting policies on impairment of assets (see note 2G(ii)). Revenue arising from operating leases is recognised in accordance with the Group's revenue recognition policies as set out in note 2Z(iv).

(c) Land held for own use under an operating lease where its fair value cannot be measured separately from the fair value of a building situated thereon at the inception of the lease, is accounted for as being held under a finance lease, unless the building is also clearly held under an operating lease (see note 2F(ii)). For these purposes, the inception of the lease is the time that the lease was first entered into by the Group, or taken over from the previous lessee, or at the date of construction of those buildings, if later.

vi Subsequent expenditure relating to the replacement of certain parts of an existing fixed asset is recognised in the carrying amount of the asset if it is probable that future economic benefit will flow to the Group and the cost of the item can be measured reliably. The carrying amount of those parts that are replaced is derecognised, with gain or loss arising therefrom dealt with in the profit and loss account.

Expenditure on repairs or maintenance of an existing fixed asset to restore or maintain the originally assessed standard of performance of that asset is charged as an expense when incurred.

vii Gains or losses arising from the retirement or disposal of a fixed asset other than an investment property are determined as the difference between the estimated net disposal proceeds and the carrying amount of the asset and are recognised as income or expense in the profit and loss account on the date of retirement or disposal. Any related revaluation surplus is transferred from the fixed asset revaluation reserve to retained profits.

***G Impairment of assets***

i *Impairment of debtors and other receivables*

Debtors and other current and non-current receivables are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If any such evidence exists, the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at initial recognition of these assets) where the effect of discounting is material.

If in a subsequent period the amount of an impairment loss decreases, the impairment loss is reversed through the profit and loss account.

ii *Impairment of other assets*

Internal and external sources of information are reviewed at each balance sheet date to identify indications that the following assets may be impaired or an impairment loss previously recognised no longer exists or may have decreased:

— fixed assets (other than properties carried at revalued amounts);

— railway construction in progress;

— property development in progress;

— prepaid land lease payments;

— deferred expenditure; and

— investments in subsidiaries, non-controlled subsidiaries, associates and jointly controlled entities.

If any such indication exists, the asset's recoverable amount is estimated.

The recoverable amount of an asset is the greater of its net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of time value of money and the risks specific to the asset. Where an asset does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the smallest group of assets that generates cash inflows independently (i.e. a cash-generating unit).

An impairment loss is recognised in the profit and loss account whenever the carrying amount of an asset, or the cash-generating unit to which it belongs, exceeds its recoverable amount.

An impairment loss is reversed if there has been a favourable change in the estimates used to determine the recoverable amount of the asset.

A reversal of impairment losses is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior periods. Reversals of impairment losses are credited to the profit and loss account in the period in which the reversals are recognised.

*H Depreciation*

i Investment properties are not depreciated.

ii Fixed assets other than investment properties and assets under construction are depreciated on a straight-line basis at rates sufficient to write off their cost or valuation, less their estimated residual value, if any, over their estimated useful lives as follows:

| | |
|---|---|
| **Land and Buildings** | |
| Self-occupied land and buildings | the shorter of 50 years and the unexpired term of the lease |
| **Civil Works** | |
| Excavation and boring | Indefinite |
| Tunnel linings, underground civil structures, overhead structures and immersed tubes | 100 years |
| Station building structures | 100 years |
| Depot structures | 80 years |
| Concrete kiosk structures | 20 years |
| Cableway station tower and theme village structures | 27 years |
| **Plant and Equipment** | |
| Rolling stock and components | 4 - 40 years |
| Platform screen doors | 35 years |
| Rail track | 7 - 30 years |
| Environmental control systems, lifts and escalators, fire protection and drainage system | 7 - 30 years |
| Power supply systems | 7 - 40 years |
| Aerial ropeway and cabin | 5 - 27 years |
| Automatic fare collection systems, metal station kiosks, and other mechanical equipment | 20 years |
| Train control and signalling equipment, station announcement systems, telecommunication systems and advertising panels | 5 - 20 years |
| Station architectural finishes | 20 - 30 years |
| Fixtures and fittings | 10 - 15 years |
| Maintenance equipment, office furniture and equipment | 10 years |
| Computer software licences and applications | 5 - 7 years |
| Cleaning equipment, computer equipment and tools | 5 years |
| Motor vehicles | 4 years |

Where parts of an item of property, plant and equipment have different useful lives, each part is depreciated separately. The useful lives of the various categories of fixed assets are reviewed annually in the light of actual asset condition, usage experience and the current asset replacement programme.

iii No depreciation is provided on assets under construction until construction is completed and the assets are ready for their intended use.

iv Depreciation on assets held under finance leases is provided at rates designed to write off the cost of the asset in equal annual amounts over the shorter of the lease term or the anticipated useful life of the asset as set out above, except in cases where title to the asset will be acquired by the Group at the end of the lease where depreciation is provided at rates designed to write off the cost of the asset in equal amounts over the anticipated useful life of the asset.

***I Construction costs***

i Costs incurred by the Group in respect of feasibility studies on proposed railway related construction projects (including consultancy fees, in-house staff costs and overheads) are dealt with as follows:

— where the proposed projects are at a preliminary review stage with no certainty of materialising, the costs concerned are written off to the profit and loss account; and

— where the proposed projects are at a detailed study stage, having been agreed in principle by the Members of the Board based on a feasible financial plan, the costs concerned are dealt with as deferred expenditure until such time as a project agreement is reached, whereupon the costs are transferred to railway construction in progress.

ii After entering into a project agreement, all costs incurred in the construction of the railway are dealt with as railway construction in progress until commissioning of the railway line, whereupon the relevant construction costs are transferred to fixed assets.

***J Property development***

i Costs incurred by the Group in respect of site preparation and land costs paid for property development are dealt with as property development in progress.

ii Payments received from developers in respect of developments are offset against the amounts in property development in progress attributable to that development. Any surplus amounts of payments received from developers in excess of the balance in property development in progress are transferred to deferred income. In these cases, further costs subsequently incurred by the Group in respect of that development are charged against deferred income.

iii Expenditure incurred on the development of properties for self-occupation by the Group is transferred to fixed assets when the occupation permits are issued and the properties are put into use.

iv When agreement is reached with a developer to redevelop an existing self-occupied property, the relevant property is revalued on an existing use basis prior to commencement of redevelopment. The surplus arising on revaluation is credited to fixed asset revaluation reserve. On commencement of redevelopment, the net book value of the property is transferred to property development in progress.

v Where an interest-free loan is provided to a developer as one of the terms of the development contract, such loan is initially stated at fair value which is its present value discounted at the prevailing market rates of interest at inception. The difference between the fair value and the face value of the loan is dealt with as property development in progress during construction and transferred to the profit and loss account upon completion of the development. Notional interest income is credited to the profit and loss account and debited to the loan over the period of the loan so that the fair value of the loan at maturity equates to its face value.

vi Profits arising from the development of properties undertaken in conjunction with property developers are recognised in the profit and loss account as follows:

— where the Group receives payments from developers at the commencement of the project, profits arising from such payments are recognised when the foundation and site enabling works are complete and acceptable for development, and after taking into account the outstanding risks and obligations, if any, retained by the Group in connection with the development;

— where the Group receives a right to a share of the net surplus from sale of the development, income is initially recognised by the Group upon the issue of occupation permits provided the amounts of revenue and costs can be estimated reliably. The interest in any unsold properties is subsequently remeasured on a basis consistent with the policy set out in note 2J(viii); and

— where the Group receives a distribution of the assets of the development, profit is recognised based on the fair value of such assets at the time of receipt and after taking into account any outstanding risks and obligations retained by the Group in connection with the development.

Upon recognition of profit, the balance of deferred income or property development in progress related to that development is credited or charged to the profit and loss account, as the case may be.

vii Where the Group is liable to pay the developer consideration for the retention of part of a property to be redeveloped, profit attributable to the Group in respect of the redevelopment (including any payment received from the developer) will be recognised in the profit and loss account when the quantum of the obligation of the Group and the amount of realised profit can be determined with reasonable accuracy.

viii Where properties are received as a profit distribution upon completion of development and are held for sale, those properties are stated at cost represented by their estimated net realisable value upon receipt. Net realisable value represents the estimated selling price less costs to be incurred in selling the properties. When properties are sold, the carrying amount of those properties is recognised as cost of properties sold in the period in which the related revenue is recognised. The amount of any write-down of properties to net realisable value is recognised as an expense in the period the write-down occurs. The amount of any reversal of any write-down of properties, arising from an increase in net realisable value, is recognised as a reduction in the cost of properties sold in the period in which the reversal occurs.

ix Where properties under construction are received as a sharing in kind from a development, these properties are initially recognised in assets under construction at fair value. Further costs incurred in the construction of those assets are capitalised into the assets under construction, which are transferred to fixed assets when substantially all the activities necessary to prepare the assets for their intended use have been completed.

***K Jointly controlled operations***

The arrangements entered into by the Group with developers for property developments without establishing separate entities are considered to be jointly controlled operations pursuant to HKAS 31 "Investments in joint ventures". Under the development arrangements, the Group is normally responsible for its own costs, including in-house staff costs and the costs of enabling works, and the developers normally undertake to pay for all other project costs such as land premium, construction costs, professional fees, etc. Such costs are deductible from the proceeds of sale before surplus proceeds are shared. In respect of its interests in such operations, the Group accounts for the costs of enabling works and land costs paid net of up-front payments received as property development in progress. In cases where up-front payments received from developers exceed the related expenditures incurred by the Group, such excess is recorded as deferred income. Expenses incurred by the Group on staff, overhead and consultancy fees in respect of these developments are also capitalised as property development in progress. The Group's share of income earned from such operations is recognised in the profit and loss account on the basis of note 2J(vi) after netting off any related balance in property development in progress at that time.

***L Investments in securities***

The Group's policies for investments in securities (other than investments in its subsidiaries, non-controlled subsidiaries, associates and jointly controlled entities), which are held for trading purpose, are as follows:

i Investments in securities are initially stated at fair value. At each balance sheet date the fair value is remeasured, with any resultant unrealised gain or loss being recognised in the profit and loss account.

ii Investments are recognised/derecognised on the date the Group commits to purchase/sell the investments or they expire.

iii Profit or loss on disposal of investments in securities are determined as the difference between the estimated net disposal proceeds and the carrying amount of the investments and are accounted for in the profit and loss account as they arise.

***M Defeasance of long-term lease payments***

Where commitments to make long-term lease payments have been defeased by the placement of securities, those commitments and securities (and income and charges arising therefrom) have been netted off in order to reflect the overall commercial effect of the arrangements. These transactions are not accounted for as leases and these liabilities and investment in securities are not recognised as obligations and assets. Any net amount of cash received from such transactions is accounted for as deferred income and is amortised over the terms of the respective lease.

***N Stores and spares***

Stores and spares used for railway and business operation are categorised as either revenue or capital. Revenue spares are stated in the balance sheet at cost, using the weighted average cost method and are recognised in the period in which the consumption occurred. Provision is made for obsolescence where appropriate. Capital items are included in fixed assets and stated at cost less aggregate depreciation and impairment losses. Depreciation is charged at the rates applicable to the relevant fixed assets against which the capital spares are held in reserve.

***O Long-term consultancy contracts***

The accounting policy for contract revenue is set out in note 2Z(iii). When the outcome of a fixed-price consultancy contract can be estimated reliably, contract costs are recognised as expense by reference to the stage of completion of the contract activity at the balance sheet date. When it is probable that total contract costs will exceed total contract revenue, the expected loss is recognised as an expense immediately. When the outcome of a consultancy contract cannot be estimated reliably, contract costs are recognised as an expense in the period in which they are incurred.

Consultancy contracts in progress at the balance sheet date are recorded in the balance sheet at the net amount of costs incurred plus recognised profit less recognised losses and progress billings, and are presented in the balance sheet as the "Gross amount due from customers for contract work" (as an asset) or the "Gross amount due to customers for contract work" (as a liability), as applicable. Progress billings not yet paid by the customer are included in the balance sheet under "Debtors, deposits and payments in advance". Amounts received before the related work is performed are included in the balance sheet, as a liability, under "Creditors, accrued charges and provisions".

***P Cash and cash equivalents***

Cash and cash equivalents comprise cash at banks and on hand, demand deposits with banks and other financial institutions, and short-term, highly liquid investments that are readily convertible into known amounts of cash and which are subject to an insignificant risk of changes in value, having been within three months of maturity at acquisition. Bank overdrafts that are repayable on demand and form an integral part of the Group's cash management are also included as a component of cash and cash equivalents for the purpose of the consolidated cash flow statement.

***Q Debtors, deposits and payments in advance***

Debtors, deposits and payments in advance are initially recognised at fair value and thereafter stated at amortised cost less impairment losses for bad and doubtful debts (see note 2G(i)), except where the effect of discounting would be immaterial or the discount is not measurable as the receivables are interest-free loans made to related parties without any fixed repayment terms. In such cases, the receivables are stated at cost less impairment losses for bad and doubtful debts.

***R Interest-bearing borrowings***

Interest-bearing borrowings are recognised initially at fair value, net of transaction costs incurred. The unhedged portion of interest-bearing borrowings are subsequently stated at amortised costs; any difference between the proceeds (net of transaction costs) and the redemption value is recognised in the profit and loss account over the period of the borrowings using the effective interest method.

Subsequent to initial recognition, the carrying amount of the hedged portion of interest-bearing borrowings is remeasured and the change in fair value attributable to the risk being hedged is recognised in the profit and loss account to offset the effect of the gain or loss on the related hedging instrument.

***S Creditors, accrued charges and provisions***

Creditors, accrued charges and provisions are stated at amortised cost if the effect of discounting would be material, otherwise they are stated at cost.

***T Derivative financial instruments and hedging activities***

The Group uses derivative financial instruments such as interest rate swaps and currency swaps to manage its interest rate and foreign exchange exposure. Based on Group policy, these instruments are used solely for reducing or eliminating financial risks associated with the Group's liabilities and not for trading or speculation purposes.

Derivatives are initially recognised at fair value and are subsequently remeasured at their fair value at each balance sheet date. The method of recognising the resulting gain or loss depends on whether the derivative is designated as a hedging instrument and the nature of the item being hedged.

Where hedge accounting applies, the Group designates derivatives employed as either: (1) a fair value hedge: to hedge the fair value of recognised liabilities; or (2) a cash flow hedge: to hedge the variability in cash flows of a recognised liability or the foreign currency risk of a firm commitment.

i *Fair value hedge*

Changes in the fair value of derivatives that are designated and qualify as fair value hedges are recorded in the profit and loss account, together with any changes in the fair value of the hedged assets or liabilities that are attributable to the hedged risk.

ii *Cash flow hedge*

The effective portion of changes in the fair value of derivatives that are designated and qualify as cash flow hedges is recognised directly in equity. The gain or loss relating to the ineffective portion is recognised immediately in the profit and loss account.

Amounts accumulated in equity are transferred to the profit and loss account in the periods when the hedged liability affects earning. However, when the firm commitment that is hedged results in the recognition of a non-financial asset, the associated gains and losses that were recognised in equity are transferred from equity and included in the initial cost or carrying amount of the asset.

When a hedging instrument expires or is sold, terminated or exercised, or when a hedge no longer meets the criteria for hedge accounting, the cumulative gain or loss existing in equity at that time shall remain in equity and is recognised when the hedged liability affects profit or loss, or when the firm commitment is recognised as a non-financial asset, in accordance with the above policy. However, when a hedged liability or a firm commitment is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the profit and loss account.

iii *Derivatives that do not qualify for hedge accounting*

Changes in the fair value of any derivative instruments that do not qualify for hedge accounting are recognised immediately in the profit and loss account.

*U Employee benefits*

i Salaries, annual leave, leave passage allowance and other costs of non-monetary benefits are accrued and recognised as an expense in the period in which the associated services are rendered by employees of the Group, except those benefits incurred for project staff in respect of construction projects and capital works, which are capitalised as part of the cost of the qualifying assets.

ii Contributions to defined contribution retirement plans, including contributions to Mandatory Provident Funds ("MPF") as required under the Hong Kong Mandatory Provident Fund Schemes Ordinance, are recognised as an expense in the profit and loss account as incurred, except those contributions for project staff incurred in respect of construction projects and capital works, which are capitalised as part of the cost of the qualifying assets.

iii The Group's net obligation in respect of defined benefit retirement plans is calculated separately for each plan by estimating the amount of future benefit that employees have earned in return for their service in the current and prior years; that benefit is discounted to determine the present value, and the fair value of any plan assets is deducted. The discount rate is the yield at balance sheet date on high quality corporate bonds that have maturity dates approximating the terms of the Group's obligations. If there is no deep market in such bonds, the market yield on government bonds would be used. The calculation is performed by a qualified actuary using the projected unit credit method.

When the benefits of a plan are improved, the portion of the increased benefit relating to past service by employees is recognised either as an expense in the profit and loss account, or capitalised as part of the cost of the relevant construction projects or capital works in the case of project related employees, as the case may be, on a straight-line basis over the average period until the benefits become vested. To the extent that the benefits vest immediately, the expense is recognised immediately in a similar manner.

In calculating the Group's obligation in respect of a plan, to the extent that any cumulative unrecognised actuarial gain or loss exceeds ten percent of the greater of the present value of the defined benefit obligation and the fair value of plan assets, that portion is recognised in the profit and loss account over the expected average remaining working lives of the employees participating in the plan. Otherwise, the actuarial gain or loss is not recognised.

Where the calculation of the Group's net obligation results in a negative amount, the asset recognised is limited to the net total of any cumulative unrecognised net actuarial losses and past service costs and the present value of any future refunds from the plan or reductions in future contributions to the plan.

iv Equity-settled share-based payments are measured at fair value at the date of grant. The fair value determined at the grant date is recognised as a staff cost, unless the original employee expenses qualify for recognition as an asset, on a straight-line basis over the vesting period and taking into account the probability that the options will vest, with a corresponding increase in the employee share-based capital reserve within equity. Fair value is measured by use of a Black-Scholes model, taking into account the terms and conditions upon which the options were granted. The expected life used in the model has been adjusted, based on management's best estimate, for the effects of non-transferability, exercise restrictions, and behavioural considerations.

During the vesting period, the number of share options that is expected to vest is reviewed. Any adjustment to the cumulative fair value recognised in prior periods is charged/credited to the profit and loss account for the period of the review, unless the original employee expenses qualify for recognition as an asset, with a corresponding adjustment to the capital reserve. On vesting date, the amount recognised as an expense is adjusted to reflect the actual number of share options that vest (with a corresponding adjustment to the capital reserve). The equity amount is recognised in the capital reserve until either the option is exercised (when it is transferred to the share premium account) or the option expires (when it is released directly to retained profits).

For cash-settled share-based payments, a liability equal to the portion of the services received is recognised at the fair value of the shares determined at each balance sheet date.

v Termination benefits are recognised when, and only when, the Group demonstrably commits itself to terminate employment or to provide benefits as a result of voluntary redundancy by having a detailed formal plan which is without realistic possibility of withdrawal.

### *V Retirement Schemes*

The Group operates an Occupational Retirement Scheme (the "MTR Corporation Limited Retirement Scheme"), which is supplemented by a top-up scheme ("MTR Corporation Limited Retention Bonus Scheme") mainly for project staff to provide extra benefits in the event of redundancy.

In addition, the Group has set up a MPF Scheme by participating in a master trust scheme provided by an independent MPF service provider to comply with the requirements under the MPF Ordinance.

Employer's contributions to the defined contribution section of the MTR Corporation Limited Retirement Scheme and the MPF Scheme are recognised in the accounts in accordance with the policy set out in note 2U(ii).

The employer's contributions paid and payable in respect of employees of the hybrid benefit section of the MTR Corporation Limited Retirement Scheme, as calculated annually by independent actuaries in accordance with the Retirement Scheme Rules and provisions of the Occupational Retirement Schemes Ordinance, are used to satisfy the pension expenses recognised in the accounts according to note 2U(iii). Any deficit or surplus thereof will be dealt with in the balance sheet as accrued or prepaid benefit expenses, as the case may be.

### *W Income tax*

i Income tax for the period comprises current tax and movements in deferred tax assets and liabilities. Income tax is recognised in the profit and loss account except to the extent that it relates to items recognised directly in equity, in which case it is recognised in equity.

ii Current tax is the expected tax payable on the taxable income for the period, using tax rates enacted or substantively enacted at the balance sheet date, and any adjustment to tax payable in respect of previous periods.

iii Deferred tax assets and liabilities arise from deductible and taxable temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and their tax bases. Deferred tax assets also arise from unused tax losses and unused tax credits.

Apart from certain limited exceptions, all deferred tax liabilities, and all deferred tax assets to the extent that it is probable that future taxable profits will be available against which the asset can be utilised, are recognised. Future taxable profits that may support the recognition of deferred tax assets arising from deductible temporary differences include those that will arise from the reversal of existing taxable temporary differences, provided those differences relate to the same taxation authority and the same taxable entity, and are expected to reverse either in the same period as the expected reversal of the deductible temporary difference or in periods into which a tax loss arising from the deferred tax asset can be carried back or forward. The same criteria are adopted when determining whether existing taxable temporary differences support the recognition of deferred tax assets arising from unused tax losses and credits, that is, those differences are taken into account if they relate to the same taxation authority and the same taxable entity, and are expected to reverse in a period, or periods, in which the tax loss or credit can be utilised.

The limited exceptions to recognition of deferred tax assets and liabilities are those temporary differences arising from the initial recognition of assets or liabilities that affect neither accounting nor taxable profit (provided they are not part of a business combination) and investments in subsidiaries to the extent that, in the case of taxable differences, the Group controls the timing of the reversal and it is probable that the differences will not reverse in the foreseeable future, or in the case of deductible differences, unless it is probable that they will reverse in the future.

The amount of deferred tax recognised is measured based on the expected manner of realisation or settlement of the carrying amount of the assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date. Deferred tax assets and liabilities are not discounted.

The carrying amount of a deferred tax asset is reviewed at each balance sheet date and is reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow the related tax benefit to be utilised. Any such reduction is reversed to the extent that it becomes probable that sufficient taxable profits will be available.

iv Current tax balances and deferred tax balances, and movements therein, are presented separately from each other and are not offset. Current tax assets are offset against current tax liabilities, and deferred tax assets against deferred tax liabilities if, and only if, the Company or the Group has the legally enforceable right to set off current tax assets against current tax liabilities and the following additional conditions are met:

— in the case of current tax assets and liabilities, the Company or the Group intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously; or

— in the case of deferred tax assets and liabilities, if they relate to income taxes levied by the same taxation authority on either:

— the same taxable entity; or

— different taxable entities, which, in each future period in which significant amounts of deferred tax liabilities or assets are expected to be settled or recovered, intend to realise the current tax assets and settle the current tax liabilities on a net basis or realise and settle simultaneously.

***X Financial guarantee contracts***

Financial guarantees are contracts that require the issuer to make specified payments to reimburse the holder of the guarantee for a loss it incurs because a specified debtor fails to make payment to the holder when due in accordance with the original or modified terms of a debt instrument.

When the Group issues a financial guarantee, where the effect is material, the fair value of the guarantee (being the transaction price, unless the fair value can otherwise be reliably estimated) after netting of any consideration received or receivable at inception is initially debited to the profit and loss account and recognised as deferred income within creditors, accrued charges and provisions.

The amount of the guarantee initially recognised as deferred income is amortised in the profit and loss account over the term of the guarantee as income from financial guarantees issued. In addition, provisions are recognised in accordance with note 2Y if and when (i) it becomes probable that the holder of the guarantee will call upon the Group under the guarantee, and (ii) the amount of that claim on the Group is expected to exceed the amount currently carried in creditors, accrued charges and provisions in respect of that guarantee, i.e. the amount initially recognised less accumulated amortisation.

***Y Provisions and contingent liabilities***

Provisions are recognised for liabilities of uncertain timing or amount when the Company or Group has a legal or constructive obligation arising as a result of a past event, it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made. Where the time value of money is material, provisions are stated at the present value of the expenditure expected to settle the obligation.

Where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably, the obligation is disclosed as a contingent liability, unless the probability of outflow of economic benefits is remote. Possible obligations, whose existence will only be confirmed by the occurrence or non-occurrence of one or more future events are also disclosed as contingent liabilities unless the probability of outflow of economic benefits is remote.

### *Z Revenue recognition*

Provided it is probable that the economic benefits associated with the transactions will flow to the Group and the amount of revenue can be measured reliably, revenue is recognised in the profit and loss account as follows:

i Fare revenue is recognised when the journey is provided.

ii Advertising income and service fees from telecommunication services provided within the railway are recognised when the services are provided.

iii Contract revenue is recognised when the outcome of a consultancy contract can be estimated reliably. Contract revenue is recognised using the percentage of completion method, measured by reference to the percentage of contract costs incurred to date to estimated total contract costs for the contract. When the outcome of a consultancy contract cannot be estimated reliably, revenue is recognised only to the extent of contract costs incurred that it is probable will be recoverable.

iv Rental income from investment properties, station kiosks and other railway premises under operating leases is accounted for in accordance with the terms of the leases. Lease incentives granted are recognised in the profit and loss account as an integral part of the aggregate net lease payments receivable. Contingent rentals are recognised as income in the accounting period in which they are earned. Property management income is recognised when the services are provided.

### *AA Operating lease charges*

i Rentals payable under operating leases are charged on a straight-line basis over the period of the lease to the profit and loss account, except for rentals payable in respect of railway construction, property development in progress and proposed capital projects which are capitalised as part of railway construction in progress, property development in progress and deferred expenditure respectively.

ii Prepaid land lease payments for land are stated at cost and are amortised on a straight-line basis over the period of the lease terms to the profit and loss account as land lease expenses.

### *BB Interest and finance charges*

Interest expense directly attributable to the financing of capital projects prior to their completion or commissioning is capitalised. Exchange differences arising from foreign currency borrowings related to the acquisition of assets are capitalised to the extent that they are regarded as an adjustment to capitalised interest costs. Interest expense attributable to other purposes is charged to the profit and loss account.

Finance charges implicit in the lease payments on assets held under finance leases are charged to the profit and loss account over the period of the lease so as to produce an approximately constant periodic rate of charge on the remaining balance of the obligations for each accounting period.

### *CC Foreign currency translation*

Foreign currency transactions during the period are translated into Hong Kong dollars and recorded at exchange rates ruling at the transaction dates. Foreign currency monetary assets and liabilities are translated into Hong Kong dollars at the exchange rates ruling at the balance sheet date. Exchange gains and losses are recognised in profit and loss account.

The results of foreign enterprises are translated into Hong Kong dollars at the average exchange rates for the period; balance sheet items are translated into Hong Kong dollars at the rates of exchange ruling at the balance sheet date. The resulting exchange differences are dealt with as a movement in reserves.

### *DD Segment reporting*

A segment is a distinguishable component of the Group that is engaged either in providing products or services (business segment), or in providing products or services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other segments.

In accordance with the Group's internal financial reporting system, the Group has chosen business segment information as the primary reporting format. As substantially all the principal operating activities of the Group are carried out in Hong Kong, no geographical segment information is provided.

Segment revenue, expenses, results, assets and liabilities include items directly attributable to a segment as well as those that can be allocated on a reasonable basis to that segment. Segment revenue, expenses, assets and liabilities are determined before intra-group balances and intra-group transactions are eliminated as part of the consolidation process, except to the extent that such intra-group balances and transactions are between group enterprises within a single segment.

Segment capital expenditure is the total cost incurred during the period to acquire segment assets that are expected to be used for more than one year.

Unallocated items mainly comprise derivative financial assets and liabilities, corporate assets, interest-bearing loans, borrowings, share of results of non-controlled subsidiaries, associates and jointly controlled entities, corporate and financing expenses and minority interests.

### *EE Related parties*

For the purposes of these accounts, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals (being members of key management personnel, significant shareholders and/or their close family members) or other entities including entities which are under the significant influence of related parties of the Group where those parties are individuals, and post-employment benefit plans which are for the benefit of employees of the Group or of any entity that is a related party of the Group.

### *FF Government grants*

Government grants are assistance by the Government in the form of transfer of resources in return for the Group's compliance to the conditions attached thereto. Government grants which represent compensation for the cost of an asset will be deducted from the cost of the asset in arriving at its carrying value to the extent of the amounts received and receivable as at the date of the balance sheet. Any excess of the amount of grant received or receivable over the cost of the asset at the balance sheet date will be carried forward as advance receipts to set off against the future cost of the asset.

## 3 Fare revenue

| | **Year ended 31 December** | | | **Six months ended 30 June** | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Fare revenue comprises: | | | | | |
| MTR Lines | 5,911 | 5,721 | 5,417 | 2,935 | 2,846 |
| Airport Express | 612 | 561 | 515 | 312 | 292 |
| | 6,523 | 6,282 | 5,932 | 3,247 | 3,138 |

The MTR Lines comprise the Kwun Tong, Tsuen Wan, Island, Tung Chung and Tseung Kwan O Lines and, effective from 1 August 2005, the Disneyland Resort Line.

**4 Non-fare revenue**

***A Station commercial and rail related business revenue***

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Station commercial and rail related business revenue comprises: | | | | | |
| Advertising | 534 | 510 | 467 | 248 | 239 |
| Kiosk rental | 391 | 344 | 298 | 208 | 190 |
| Telecommunication income | 259 | 334 | 238 | 110 | 138 |
| Consultancy income | 199 | 211 | 182 | 82 | 98 |
| Miscellaneous business revenue | 159 | 156 | 126 | 87 | 70 |
| | 1,542 | 1,555 | 1,311 | 735 | 735 |

***B Rental, management and other business income***

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Rental income was attributable to: | | | | | |
| Telford Plaza | 492 | 470 | 388 | 256 | 246 |
| Luk Yeung Galleria | 122 | 120 | 117 | 57 | 60 |
| Paradise Mall | 112 | 111 | 115 | 55 | 57 |
| Maritime Square | 281 | 252 | 224 | 148 | 139 |
| International Finance Centre | 128 | 122 | 77 | 72 | 64 |
| Other properties | 128 | 108 | 73 | 122 | 58 |
| | 1,263 | 1,183 | 994 | 710 | 624 |
| Property management income | 146 | 126 | 108 | 80 | 67 |
| Property agency income | 3 | 7 | 6 | — | 2 |
| | 1,412 | 1,316 | 1,108 | 790 | 693 |
| Ngong Ping 360 business revenue | 64 | — | — | 80 | — |
| | 1,476 | 1,316 | 1,108 | 870 | 693 |

Included in rental income for the six months ended 30 June 2007 is service income of HK$31 million (2006: HK$64 million; 2005: HK$63 million; 2004: HK$63 million) relating to the provision of air conditioning services.

Ngong Ping 360 business revenue comprises revenue generated from the Tung Chung cable car operations and related businesses at the Ngong Ping Theme Village, which commenced on 18 September 2006.

## 5 Operating expenses before depreciation

*A* Staff costs comprise:

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Amount charged to profit and loss account under: | | | | | |
| — staff costs and related expenses | 1,653 | 1,614 | 1,546 | 784 | 777 |
| — repairs and maintenance | 58 | 50 | 46 | 29 | 28 |
| — expenses relating to station commercial and rail related businesses | 145 | 145 | 129 | 66 | 71 |
| — expenses relating to property ownership, management and other businesses | 40 | 40 | 32 | 22 | 17 |
| — project study and business development expenses | 115 | 32 | 28 | 56 | 32 |
| — other line items | 42 | 51 | 54 | 9 | 19 |
| Amount capitalised in: | | | | | |
| — railway construction in progress | 40 | 136 | 158 | 23 | 41 |
| — property development in progress | 79 | 76 | 74 | 38 | 37 |
| — assets under construction and other projects | 309 | 261 | 247 | 160 | 146 |
| Amount recoverable | 197 | 166 | 134 | 107 | 94 |
| Total staff costs | 2,678 | 2,571 | 2,448 | 1,294 | 1,262 |

Included in operating expenses are the following:

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Share options granted to directors and employees | 9 | 5 | 4 | 2 | 5 |
| Contributions to defined contribution plans and Mandatory Provident Fund | 17 | 12 | 16 | 9 | 7 |
| Expense recognised in respect of defined benefit plans (note 43E) | 123 | 134 | 138 | 48 | 77 |
| | 149 | 151 | 158 | 59 | 89 |

*B* Repairs and maintenance costs relate mainly to contracted maintenance and revenue works. Other routine repairs and maintenance works are performed by in-house operations, the costs of which are included under staff costs and stores and spares consumed.

*C* Project study and business development expenses comprise:

| *in HK$ million* | Year ended 31 December 2006 | Year ended 31 December 2005 | Year ended 31 December 2004 | Six months ended 30 June 2007 *(unaudited)* | Six months ended 30 June 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Business development expenses | 245 | 129 | 95 | 102 | 73 |
| Tseung Kwan O South Station Project (note 17) | — | — | 49 | — | — |
| South Island Line | — | — | 15 | — | — |
| Miscellaneous project study expenses | 22 | 13 | 8 | 10 | 11 |
| | 267 | 142 | 167 | 112 | 84 |

Business development expenses relate mainly to studies on business opportunities in China and Europe in line with the Group's business strategy.

*D* Included in general and administration expenses and other expenses are the following charges/(credits):

| *in HK$ million* | Year ended 31 December 2006 | Year ended 31 December 2005 | Year ended 31 December 2004 | Six months ended 30 June 2007 *(unaudited)* | Six months ended 30 June 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Auditors' remuneration | | | | | |
| — audit services | 5 | 4 | 4 | — | — |
| — tax services | 1 | 1 | 1 | — | — |
| — other services | — | 2 | — | 1 | — |
| Write-back of deficit on revaluation of self-occupied land and buildings (note 16C) | — | — | (69) | — | — |
| Loss on disposal of fixed assets | 37 | 40 | 19 | 14 | 15 |
| Derivative financial instruments: | | | | | |
| — foreign exchange contracts - ineffective portion of cash flow hedges | (8) | 6 | — | — | (8) |
| — transfer from hedging reserve | 1 | 3 | — | 1 | — |
| Amortisation of land lease expenses (note 20) | 14 | 13 | 13 | 7 | 7 |
| Unrealised (gain)/loss on revaluation of investment in securities | (2) | — | 1 | 1 | — |

*E* Operating lease expenses charged to the profit and loss account comprise:

| *in HK$ million* | Year ended 31 December 2006 | 2005 | 2004 | Six months ended 30 June 2007 *(unaudited)* | 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Shopping centre, office building and staff quarters | 46 | 10 | 10 | 29 | 14 |
| Amount capitalised | (1) | (2) | (3) | (1) | (1) |
| | 45 | 8 | 7 | 28 | 13 |

## 6 Remuneration of Members of the Board and the Executive Directorate

### *A Remuneration of Members of the Board and the Executive Directorate*

i The emoluments of the Members of the Board and the Executive Directorate of the Company were as follows:

| *in HK$ million* | Fees | Base pay, allowances, and benefits in kind | Retirement scheme contribution | Variable remuneration related to performance | Total |
|---|---|---|---|---|---|
| **Year ended 31 December 2006** | | | | | |
| Members of the Board | | | | | |
| — Raymond Ch'ien Kuo-fung | 1.0 | — | — | — | 1.0 |
| — Cheung Yau-kai | 0.2 | — | — | — | 0.2 |
| — David Gordon Eldon | 0.2 | — | — | — | 0.2 |
| — Christine Fang Meng-sang | 0.2 | — | — | — | 0.2 |
| — Edward Ho Sing-tin | 0.3 | — | — | — | 0.3 |
| — Lo Chung-hing | 0.2 | — | — | — | 0.2 |
| — T. Brian Stevenson | 0.3 | — | — | — | 0.3 |
| — Sarah Liao Sau-tung | 0.2 | — | — | — | 0.2 |
| — Frederick Ma Si-hang | 0.2 | — | — | — | 0.2 |
| — Alan Wong Chi-kong | 0.2 | — | — | — | 0.2 |
| Members of the Executive Directorate | | | | | |
| — Chow Chung-kong | — | 5.9 | —* | 4.2 | 10.1 |
| — Russell John Black | — | 3.7 | 0.3 | 1.0 | 5.0 |
| — William Chan Fu-keung | — | 3.5 | 0.3 | 1.0 | 4.8 |
| — Thomas Ho Hang-kwong | — | 3.6 | 0.3 | 0.9 | 4.8 |
| — Lincoln Leong Kwok-kuen | — | 3.5 | 0.5 | 1.0 | 5.0 |
| — Francois Lung Ka-kui | — | 3.4 | 0.4 | 0.9 | 4.7 |
| — Andrew McCusker | — | 3.5 | 0.3 | 0.9 | 4.7 |
| — Leonard Bryan Turk | — | 3.5 | 0.3 | 1.0 | 4.8 |
| | 3.0 | 30.6 | 2.4 | 10.9 | 46.9 |

* C K Chow is a member of the Company's Mandatory Provident Fund Scheme. The total contributions paid by the Company in each of the years 2006, 2005 and 2004 were HK$12,000.

| *in HK$ million* | **Fees** | **Base pay, allowances, and benefits in kind** | **Retirement scheme contribution** | **Variable remuneration related to performance** | **Total** |
|---|---|---|---|---|---|
| **Year ended 31 December 2005** | | | | | |
| Members of the Board | | | | | |
| — Raymond Ch'ien Kuo-fung | 1.0 | — | — | — | 1.0 |
| — Cheung Yau-kai | 0.2 | — | — | — | 0.2 |
| — David Gordon Eldon | 0.2 | — | — | — | 0.2 |
| — Christine Fang Meng-sang | 0.2 | — | — | — | 0.2 |
| — Edward Ho Sing-tin | 0.3 | — | — | — | 0.3 |
| — Lo Chung-hing | 0.2 | — | — | — | 0.2 |
| — T. Brian Stevenson | 0.3 | — | — | — | 0.3 |
| — Robert Charles Law Footman (retired on 18 June 2005) | 0.1 | — | — | — | 0.1 |
| — Sarah Liao Sau-tung | 0.2 | — | — | — | 0.2 |
| — Frederick Ma Si-hang | 0.2 | — | — | — | 0.2 |
| — Alan Wong Chi-kong (appointed on 18 June 2005) | 0.1 | — | — | — | 0.1 |
| Members of the Executive Directorate | | | | | |
| — Chow Chung-kong | — | 5.7 | —* | 4.2 | 9.9 |
| — Russell John Black | — | 3.5 | 0.3 | 1.0 | 4.8 |
| — William Chan Fu-keung | — | 3.5 | 0.3 | 0.9 | 4.7 |
| — Philip Gaffney (retired on 5 December 2005) | — | 3.9 | 0.3 | 1.1 | 5.3 |
| — Thomas Ho Hang-kwong | — | 3.5 | 0.3 | 1.0 | 4.8 |
| — Lincoln Leong Kwok-kuen | — | 3.4 | 0.5 | 1.0 | 4.9 |
| — Francois Lung Ka-kui (appointed on 26 September 2005) | — | 0.9 | 0.1 | 0.2 | 1.2 |
| — Andrew McCusker (appointed on 1 October 2005) | — | 0.9 | 0.1 | 0.2 | 1.2 |
| — Leonard Bryan Turk | — | 3.5 | 0.3 | 0.9 | 4.7 |
| | 3.0 | 28.8 | 2.2 | 10.5 | 44.5 |

In December 2005, Philip Gaffney received a lump sum benefit payment of HK$11.6 million from the MTR Corporation Limited Retirement Scheme upon retirement.

| *in HK$ million* | **Fees** | **Base pay, allowances, and benefits in kind** | **Retirement scheme contribution** | **Variable remuneration related to performance** | **Total** |
|---|---|---|---|---|---|
| **Year ended 31 December 2004** | | | | | |
| Members of the Board | | | | | |
| — Raymond Ch'ien Kuo-fung | 1.0 | — | — | — | 1.0 |
| — Cheung Yau-kai | 0.2 | — | — | — | 0.2 |
| — David Gordon Eldon | 0.2 | — | — | — | 0.2 |
| — Christine Fang Meng-sang | 0.2 | — | — | — | 0.2 |
| — Edward Ho Sing-tin | 0.3 | — | — | — | 0.3 |
| — Lo Chung-hing | 0.2 | — | — | — | 0.2 |
| — T. Brian Stevenson | 0.3 | — | — | — | 0.3 |
| — Robert Charles Law Footman | 0.2 | — | — | — | 0.2 |
| — Sarah Liao Sau-tung | 0.2 | — | — | — | 0.2 |
| — Frederick Ma Si-hang | 0.2 | — | — | — | 0.2 |
| Members of the Executive Directorate | | | | | |
| — Chow Chung-kong | — | 5.6 | —* | 3.4 | 9.0 |
| — Russell John Black | — | 3.6 | 0.5 | 0.8 | 4.9 |
| — William Chan Fu-keung | — | 3.6 | 0.5 | 0.8 | 4.9 |
| — Philip Gaffney | — | 3.9 | 0.6 | 0.8 | 5.3 |
| — Thomas Ho Hang-kwong | — | 3.6 | 0.5 | 0.8 | 4.9 |
| — Lincoln Leong Kwok-kuen | — | 3.4 | 0.4 | 0.8 | 4.6 |
| — Leonard Bryan Turk | — | 3.7 | 0.5 | 0.8 | 5.0 |
| | 3.0 | 27.4 | 3.0 | 8.2 | 41.6 |

| *in HK$ million* | **Fees** | **Base pay, allowances, and benefits in kind** | **Retirement scheme contribution** | **Variable remuneration related to performance[+]** | **Total** |
|---|---|---|---|---|---|
| **Six months ended 30 June 2007 (unaudited)** | | | | | |
| Members of the Board | | | | | |
| — Raymond Ch'ien Kuo-fung | 0.5 | — | — | — | 0.5 |
| — Cheung Yau-kai | 0.1 | — | — | — | 0.1 |
| — David Gordon Eldon | 0.1 | — | — | — | 0.1 |
| — Christine Fang Meng-sang | 0.1 | — | — | — | 0.1 |
| — Edward Ho Sing-tin | 0.1 | — | — | — | 0.1 |
| — Lo Chung-hing | 0.1 | — | — | — | 0.1 |
| — T. Brian Stevenson | 0.2 | — | — | — | 0.2 |
| — Sarah Liao Sau-tung | 0.1 | — | — | — | 0.1 |
| — Frederick Ma Si-hang | 0.1 | — | — | — | 0.1 |
| — Alan Wong Chi-kong | 0.1 | — | — | — | 0.1 |
| Members of the Executive Directorate | | | | | |
| — Chow Chung-kong | — | 2.9 | —[#] | — | 2.9 |
| — Russell John Black | — | 1.8 | 0.1 | — | 1.9 |
| — William Chan Fu-keung | — | 1.8 | 0.1 | — | 1.9 |
| — Thomas Ho Hang-kwong | — | 1.8 | 0.1 | — | 1.9 |
| — Lincoln Leong Kwok-kuen | — | 1.9 | 0.2 | — | 2.1 |
| — Francois Lung Ka-kui | — | 1.7 | 0.2 | — | 1.9 |
| — Andrew McCusker | — | 1.7 | 0.1 | — | 1.8 |
| — Leonard Bryan Turk | — | 1.8 | 0.1 | — | 1.9 |
| | 1.5 | 15.4 | 0.9 | — | 17.8 |

+ No variable remuneration was paid for the six months ended 30 June 2007 and 2006 as this is a payment made annually based on the Company's annual operating results.

# C K Chow is a member of the Company's Mandatory Provident Fund Scheme. The total contributions paid by the Company in each of the six months ended 30 June 2007 and 2006 were HK$6,000.

| *in HK$ million* | **Fees** | **Base pay, allowances, and benefits in kind** | **Retirement scheme contribution** | **Variable remuneration related to performance+** | **Total** |
|---|---|---|---|---|---|
| **Six months ended 30 June 2006 (unaudited)** | | | | | |
| Members of the Board | | | | | |
| — Raymond Ch'ien Kuo-fung | 0.5 | — | — | — | 0.5 |
| — Cheung Yau-kai | 0.1 | — | — | — | 0.1 |
| — David Gordon Eldon | 0.1 | — | — | — | 0.1 |
| — Christine Fang Meng-sang | 0.1 | — | — | — | 0.1 |
| — Edward Ho Sing-tin | 0.1 | — | — | — | 0.1 |
| — Lo Chung-hing | 0.1 | — | — | — | 0.1 |
| — T. Brian Stevenson | 0.2 | — | — | — | 0.2 |
| — Sarah Liao Sau-tung | 0.1 | — | — | — | 0.1 |
| — Frederick Ma Si-hang | 0.1 | — | — | — | 0.1 |
| — Alan Wong Chi-kong | 0.1 | — | — | — | 0.1 |
| Members of the Executive Directorate | | | | | |
| — Chow Chung-kong | — | 3.0 | —# | — | 3.0 |
| — Russell John Black | — | 1.8 | 0.1 | — | 1.9 |
| — William Chan Fu-keung | — | 1.8 | 0.1 | — | 1.9 |
| — Thomas Ho Hang-kwong | — | 1.8 | 0.1 | — | 1.9 |
| — Lincoln Leong Kwok-kuen | — | 1.8 | 0.2 | — | 2.0 |
| — Francois Lung Ka-kui | — | 1.7 | 0.2 | — | 1.9 |
| — Andrew McCusker | — | 1.7 | 0.1 | — | 1.8 |
| — Leonard Bryan Turk | — | 1.8 | 0.1 | — | 1.9 |
| | 1.5 | 15.4 | 0.9 | — | 17.8 |

The above emoluments do not include the fair value of share options, as estimated at the date of grant, granted to Lincoln K K Leong and Francois K K Lung under the Company's New Joiners Share Option Scheme, whose entitlements are as follows:

(a) The entitlement of Lincoln K K Leong was fully vested in July 2006, as such, no share-based payments in respect of his entitlement was recognised for the six months ended 30 June 2007 (2006: HK$0.3 million; 2005: HK$0.6 million; 2004: HK$0.6 million).

(b) The options granted to Francois K K Lung lapsed on 17 October 2006 in accordance with the terms of the New Joiners Share Option Scheme and the fair value of his share-based payments for the year ended 31 December 2005 was HK$0.3 million (2004: nil). He was granted options in respect of 1,066,000 share on 22 March 2007, the respective fair value of the share-based payments for the six months ended 30 June 2007 was HK$0.4 million.

The details of directors' interest in the Company's shares as at 30 June 2007 are disclosed as follows:

| | Number of ordinary shares held | | | Derivatives | | | |
|---|---|---|---|---|---|---|---|
| | | | | Share options | Other | | |
| **Member of the Board or Executive Directorate** | **Personal* interests** | **Family+ interests** | **Corporate interests** | **Personal* interests** | **Personal* interests** | **Total interests** | **Percentage of aggregate interests to total issued share capital** |
| Chow Chung-kong | — | — | — | — | 418,017 | 418,017 | 0.00748 |
| T. Brian Stevenson | 4,755 | — | — | — | — | 4,755 | 0.00009 |
| Christine Fang Meng-sang | 1,712 | — | — | — | — | 1,712 | 0.00003 |
| Russell John Black | 54,748 | — | — | — | — | 54,748 | 0.00098 |
| William Chan Fu-keung | 46,960 | — | — | 217,500 | — | 264,460 | 0.00473 |
| Thomas Ho Hang-kwong | 54,640 | 2,541 | — | 321,000 | — | 378,181 | 0.00677 |
| Lincoln Leong Kwok-kuen | 23,000 | — | 23,000 | 1,043,000 | 160,000 | 1,249,000 | 0.02235 |
| Francois Lung Ka-kui | 46,000 | 2,500 | — | 1,066,000 | — | 1,114,500 | 0.01994 |

* Interests as beneficial owner

+ Interests of spouse or child under 18 as beneficial owner

In addition, C K Chow did not participate in the Company's Pre-Global Offering Share Option Scheme and New Joiners Share Option Scheme. He was entitled to receive an equivalent value in cash of 700,000 shares on completion of his initial three-year contract on 30 November 2006. Pursuant to this contract and following the completion of the contract period, HK$13,396,600 was paid to C K Chow on 1 December 2006 (note 41B).

The aggregate emoluments of Members of the Board and the Executive Directorate for the six months ended 30 June 2007 pursuant to section 161 of the Hong Kong Companies Ordinance was HK$18.2 million (2006: HK$60.6 million; 2005: HK$45.4 million; 2004: HK$42.2 million).

ii C K Chow has a derivative interest in respect of 418,017 shares within the meaning of Part XV of the Securities and Futures Ordinance ("SFO"). That derivative interest represents C K Chow's entitlement to receive an equivalent value in cash of 418,017 shares on completion of his three-year contract ending on 30 November 2009.

On 12 April 2007, Lincoln K K Leong was granted a derivative interest in respect of 160,000 shares in the Company within the meaning of Part XV of the SFO. The derivative interest represents Lincoln K K Leong's entitlement to receive an equivalent value in cash of 160,000 shares on 9 April 2010.

The arrangements were offered to C K Chow and Lincoln K K Leong in order to provide a competitive level of compensation which is to be closely tied to the performance of the Company.

iii 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 (Chapter 556 of the Laws of Hong Kong)) to retirement by rotation and re-election at the Company's annual general meetings in accordance with Articles 87 and 88 of the Company's Articles of Association. Dr. Raymond Ch'ien Kuo-fung, 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. In July 2006, he was re-appointed as the non-executive Chairman of the Company until 31 July 2007. In July 2007, he was re-appointed again as the non-executive Chairman of the Company with effect from 1 August 2007 for a term up to 31 December 2007 or the day to be appointed by the Secretary for Transport and Housing by notice published in the Gazette under the Rail Merger Ordinance, whichever is the earlier. All of the five individuals with the highest emoluments are Members of the Executive Directorate whose emoluments are disclosed above.

***B Share options***

Details of the options granted to Members of the Executive Directorate are as follows:

i *Pre-Global Offering Share Option Scheme*

Under the Company's Pre-Global Offering Share Option Scheme ("Pre-IPO Option Scheme") described in note 41A(i), each Member of the Executive Directorate, except C K Chow, Lincoln K K Leong, Francois K K Lung and Andrew McCusker, was granted options on 20 September 2000 to acquire 1,066,000 shares. C K Chow, Lincoln K K Leong and Francois K K Lung joined the Company on 1 December 2003, 1 February 2002 and 26 September 2005 respectively, and are not beneficiaries of the Pre-IPO Option Scheme. Andrew McCusker was granted 266,500 options on 20 September 2000 under the Pre-IPO Option Scheme and no additional share options were granted upon his appointment as a Member of the Executive Directorate on 1 October 2005.

Under the vesting terms of the Pre-IPO Option Scheme, each eligible Member of the Executive Directorate must continue to beneficially own (i) at all times after 26 October 2001, at least 23,000 shares; and (ii) at all times after 26 October 2002, at least 46,000 shares, in each case, up to and including the date on which he has exercised his option in full or the date on which his option lapses (whichever is earlier).

Options outstanding in respect of each eligible Member of the Executive Directorate as at 30 June 2007 are as follows:

| Executive Directorate | Date of grant | No. of options granted | Period during which rights exercisable (day/month/year) | Options outstanding as at 1 January 2007 | Options vested during the period | Options lapsed during the period | Options exercised during the period | Exercise price per share of options | Options outstanding as at 30 June 2007 | Weighted average closing price of shares immediately before the date(s) on which options were exercised |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | *HK$* | | *HK$* |
| William Chan Fu-keung | 20/9/2000 | 1,066,000 | 5/4/2001 - 11/9/2010 | 217,500 | — | — | — | 8.44 | 217,500 | — |
| Thomas Ho Hang-kwong | 20/9/2000 | 1,066,000 | 5/4/2001 - 11/9/2010 | 321,000 | — | — | — | 8.44 | 321,000 | — |

ii *New Joiners Share Option Scheme*

Under the New Joiners Share Option Scheme ("New Option Scheme") as described in note 41A(ii), Lincoln K K Leong and Francois K K Lung, Members of the Executive Directorate, were granted options to acquire 1,066,000 shares on 1 August 2003 and 27 September 2005 respectively.

Under the vesting terms of the New Option Scheme, Lincoln K K Leong must continue to beneficially own (i) at all times on and after 4 August 2004, at least 23,000 shares; and (ii) at all times on and after 4 August 2005, at least 46,000 shares, up to and including the date on which he has exercised his option in full or the date on which his option lapses (whichever is earlier).

Under the vesting terms of the New Option Scheme, Francois K K Lung was required to beneficially own at all times on and after 17 October 2006, at least 23,000 shares up to and including the date on which he has exercised his option in full or the date on which his option lapses (whichever is earlier). Francois K K Lung's options lapsed on 17 October 2006 in accordance with the terms of the New Option Scheme.

On 22 March 2007, Francois K K Lung was granted options to acquire 1,066,000 shares under the New Option Scheme. Under the vesting terms of the New Option Scheme, Francois K K Lung was required to beneficially own (i) at all times on and after 9 April 2008, at least 23,000 shares; and (ii) at all times on and after 9 April 2009, at least 46,000 shares, up to and including the date on which he has exercised his option in full or the date on which his option lapses (whichever is earlier).

Options outstanding in respect of Lincoln K K Leong and Francois K K Lung as at 30 June 2007 are as follows:

| Executive Directorate | Date of grant | No. of options granted | Period during which rights exercisable (day/month/year) | Options outstanding as at 1 January 2007 | 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$* | Options outstanding as at 30 June 2007 | Weighted average closing price of shares immediately before the date(s) on which options were exercised *HK$* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 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 | 22/3/2007 | 1,066,000 | 19/3/2008 - 19/3/2017 | — | 1,066,000 | — | — | — | 19.404 | 1,066,000 | — |

## 7 Profit on property developments

| *in HK$ million* | Year ended 31 December 2006 | 2005 | 2004 | Six months ended 30 June 2007 *(unaudited)* | 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Profit on property developments comprises: | | | | | |
| Transfer from deferred income on | | | | | |
| — up-front payments (note 18B(i)) | 1,213 | 1,794 | 1,601 | 510 | 621 |
| — sharing in kind (note 18B(ii)) | 555 | 95 | 1,008 | 42 | 295 |
| Share of surplus from development | 3,724 | 3,296 | 1,966 | 1,100 | 3,137 |
| Income recognised from sharing in kind | 342 | 971 | — | 21 | 26 |
| Other overhead costs | (17) | (11) | (7) | (9) | (7) |
| | 5,817 | 6,145 | 4,568 | 1,664 | 4,072 |

## 8 Depreciation

| *in HK$ million* | Year ended 31 December 2006 | 2005 | 2004 | Six months ended 30 June 2007 *(unaudited)* | 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Depreciation comprised charges on: | | | | | |
| Railway operations | | | | | |
| — on fixed assets held under finance leases | 19 | 19 | 19 | 10 | 10 |
| — on other railway fixed assets | 2,526 | 2,502 | 2,341 | 1,280 | 1,236 |
| Assets relating to station commercial and rail related businesses | 82 | 126 | 117 | 32 | 47 |
| Unallocated corporate assets | 47 | 35 | 22 | 26 | 22 |
| | 2,674 | 2,682 | 2,499 | 1,348 | 1,315 |

## 9 Interest and finance charges

| *in HK$ million* | Year ended 31 December 2006 | 2005 | 2004 | Six months ended 30 June 2007 *(unaudited)* | 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Interest expenses in respect of: | | | | | |
| Bank loans, overdrafts and capital market instruments wholly repayable within 5 years | 1,143 | 934 | 668 | 488 | 547 |
| Bank loans and capital market instruments not wholly repayable within 5 years | 504 | 485 | 764 | 250 | 255 |
| Obligations under finance leases | 15 | 25 | 35 | 3 | 9 |
| Finance charges | 25 | 33 | 35 | 9 | 13 |
| Exchange (gain)/loss | (2) | 7 | 2 | (1) | (1) |
| Derivative financial instruments: | | | | | |
| Fair value hedges | (19) | 107 | — | 59 | 40 |
| Cash flow hedges | | | | | |
| — transfer from hedging reserve | (18) | 29 | — | — | (11) |
| — ineffective portion | 2 | 1 | — | — | — |
| Derivatives not qualified as hedges | 8 | (130) | — | (6) | (2) |
| | (27) | 7 | — | 53 | 27 |
| Interest expenses capitalised | (126) | (114) | (47) | (46) | (68) |
| | 1,532 | 1,377 | 1,457 | 756 | 782 |
| Interest income in respect of: | | | | | |
| Deposits with banks and other financial institutions | (9) | (15) | (5) | (14) | (5) |
| Staff housing loans | (2) | (1) | (2) | (1) | (1) |
| | (11) | (16) | (7) | (15) | (6) |
| Interest income from loan to a property developer | (123) | — | — | (87) | (37) |
| | 1,398 | 1,361 | 1,450 | 654 | 739 |

Interest expenses have been capitalised at the average cost of borrowings to the Group calculated on a monthly basis. The average interest rates for each month varied from 5.6% to 5.8% per annum during the six months ended 30 June 2007 (2006: 5.4% to 5.6% per annum; 2005: 4.8% to 5.6% per annum; 2004: 4.1% to 5.2% per annum).

## 10 Share of profits less losses of non-controlled subsidiaries and associates

Share of profits less losses of non-controlled subsidiaries and associates comprises:

| in HK$ million | Year ended 31 December 2006 | 2005 | 2004 | Six months ended 30 June 2007 (unaudited) | 2006 (unaudited) |
|---|---|---|---|---|---|
| Share of profit before taxation of non-controlled subsidiaries (note 21) | 80 | 47 | 44 | 50 | 36 |
| Share of loss of associates (note 23) | (23) | (31) | — | — | (12) |
| | 57 | 16 | 44 | 50 | 24 |
| Share of income tax of non-controlled subsidiaries (note 21) | (12) | (7) | (5) | (8) | (8) |
| | 45 | 9 | 39 | 42 | 16 |

## 11 Income tax

### *A Income tax in the consolidated profit and loss account represents:*

| in HK$ million | Year ended 31 December 2006 | 2005 | 2004 | Six months ended 30 June 2007 (unaudited) | 2006 (unaudited) |
|---|---|---|---|---|---|
| Current tax | | | | | |
| — overseas tax for the year/period | 2 | 1 | 4 | — | 1 |
| Deferred tax | | | | | |
| — origination and reversal of temporary differences on: | | | | | |
| — change in fair value of investment properties | 381 | 490 | 435 | 429 | 259 |
| — utilisation of tax losses | 1,197 | 827 | 441 | 423 | 1,005 |
| — others | (169) | 231 | 250 | 27 | (281) |
| | 1,409 | 1,548 | 1,126 | 879 | 983 |
| | 1,411 | 1,549 | 1,130 | 879 | 984 |

No provision for current Hong Kong Profits Tax has been made in the consolidated profit and loss account in respect of the Company and its subsidiaries, as the Company and its subsidiaries either have substantial accumulated tax losses brought forward which are available for set off against current period's assessable profits or have sustained tax losses for the six months ended 30 June 2007. Taxation for overseas subsidiaries is charged at the appropriate current rates of taxation ruling in the relevant countries.

Provision for deferred tax on temporary differences arising in Hong Kong is calculated at Hong Kong Profits Tax rate at 17.5% (2006: 17.5%; 2005: 17.5%; 2004: 17.5%).

*B* ***Reconciliation between tax expense and accounting profit at applicable tax rates***

| | Year ended 31 December | | | | | |
|---|---|---|---|---|---|---|
| | **2006** | | **2005** | | **2004** | |
| | *HK$ million* | % | *HK$ million* | % | *HK$ million* | % |
| Profit before taxation | 9,169 | | 10,012 | | 7,673 | |
| Notional tax on profit before taxation, calculated at the rates applicable to profits in the tax jurisdictions concerned | 1,584 | 17.3 | 1,737 | 17.3 | 1,330 | 17.3 |
| Tax effect of non-deductible expenses | 27 | 0.3 | 30 | 0.3 | 23 | 0.3 |
| Tax effect of non-taxable revenue | (230) | (2.5) | (228) | (2.3) | (214) | (2.8) |
| Tax effect of unused tax losses not recognised | 30 | 0.3 | 10 | 0.1 | 2 | — |
| Tax effect of tax losses not recognised in previous years | — | — | — | — | (11) | (0.1) |
| Actual tax expenses | 1,411 | 15.4 | 1,549 | 15.4 | 1,130 | 14.7 |

| | Six months ended 30 June | | | |
|---|---|---|---|---|
| | **2007** | | **2006** | |
| | *(unaudited)* | | *(unaudited)* | |
| | *HK$ million* | % | *HK$ million* | % |
| Profit before taxation | 4,951 | | 6,151 | |
| Notional tax on profit before taxation, calculated at the rates applicable to profits in the tax jurisdictions concerned | 855 | 17.3 | 1,068 | 17.4 |
| Tax effect of non-deductible expenses | 39 | 0.8 | 9 | 0.1 |
| Tax effect of non-taxable revenue | (15) | (0.3) | (96) | (1.6) |
| Tax effect of unused tax losses not recognised | — | — | 3 | — |
| Actual tax expenses | 879 | 17.8 | 984 | 15.9 |

**12 Profit attributable to equity shareholders**

The consolidated profit attributable to equity shareholders for the six months ended 30 June 2007 includes a profit of HK$4,000 million (2006: HK$7,717 million; 2005: HK$8,364 million; 2004: HK$6,526 million) which has been dealt with in the accounts of the Company.

## 13 Dividends

Dividends paid and proposed to equity shareholders of the Company comprised:

| in HK$ million | Year ended 31 December 2006 | Year ended 31 December 2005 | Year ended 31 December 2004 | Six months ended 30 June 2007 (unaudited) | Six months ended 30 June 2006 (unaudited) |
|---|---|---|---|---|---|
| Dividends paid and payable in respect of 2007 | | | | | |
| — Interim dividend declared after the balance sheet date of 14 cents (2006: 14 cents; 2005: 14 cents; 2004: 14 cents) per share | 774 | 764 | 750 | 782 | 774 |
| — Final dividend of 28 cents (2005: 28 cents; 2004: 28 cents) per share | 1,554 | 1,535 | 1,509 | — | — |
| | 2,328 | 2,299 | 2,259 | 782 | 774 |
| Dividend in respect of 2006 | | | | | |
| — Final dividend of 28 cents (2005: 28 cents; 2004: 28 cents; 2003: 28 cents) per share approved and paid in 2007 | 1,535 | 1,509 | 1,481 | 1,554 | 1,535 |

The interim dividend declared after the balance sheet date has not been recognised as a liability at the balance sheet date.

Scrip dividend elections were offered to all shareholder with Hong Kong addresses for dividend payments up to 2005 interim dividend and to all shareholders except shareholders with registered addresses in the United States of America or any of its territories or possessions for dividends paid and payable thereafter. The Company's majority shareholder, The Financial Secretary Incorporated ("FSI"), had elected to receive part of its entitlement to dividends in the form of scrip to the extent necessary to ensure that the amount payable in cash would not exceed 50% of the total dividend payable. Details of dividends paid to the FSI are contained in note 45L. On 8 November 2006, the Government agreed to extend the scrip dividend arrangement for another three financial years until the financial year ending 31 December 2009.

Pursuant to the financing arrangement under the Disneyland Resort Line Project Agreement entered into between the Group and the Government, HK$37 million cash dividend declared and payable to the Government in 2004 has been waived (note 45E).

## 14 Earnings per share

### *A Basic earnings per share*

The calculation of basic earnings per share is based on the profit for the six months ended 30 June 2007 attributable to equity shareholders of HK$4,071 million (2006: HK$7,759 million; 2005: HK$8,450 million; 2004: HK$6,543 million) and the weighted average number of ordinary shares of 5,550,144,410 in issue during the period (2006: 5,510,345,238; 2005: 5,430,594,654; 2004: 5,331,253,996), calculated as follows:

| | Year ended 31 December | | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| Issued ordinary shares at 1 January | 5,481,856,439 | 5,389,999,974 | 5,288,695,393 |
| Effect of scrip dividends issued | 25,713,468 | 37,418,279 | 36,916,916 |
| Effect of share options exercised | 2,775,331 | 3,176,401 | 5,641,687 |
| Weighted average number of ordinary shares at 31 December | 5,510,345,238 | 5,430,594,654 | 5,331,253,996 |

| | Six months ended 30 June | |
|---|---|---|
| | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Issued ordinary shares at 1 January | 5,548,613,951 | 5,481,856,439 |
| Effect of scrip dividends issued | 1,082,419 | 952,517 |
| Effect of share options exercised | 448,040 | 1,576,305 |
| Weighted average number of ordinary shares at 30 June | 5,550,144,410 | 5,484,385,261 |

### *B Diluted earnings per share*

The calculation of diluted earnings per share is based on the profit for the six months ended 30 June 2007 attributable to equity shareholders of HK$4,071 million (2006: HK$7,759 million; 2005: HK$8,450 million; 2004: HK$6,543 million) and the weighted average number of ordinary shares of 5,555,165,343 in issue during the period (2006: 5,516,115,460; 2005: 5,436,752,536; 2004: 5,337,217,673) after adjusting for the number of dilutive potential ordinary shares under the employee share option schemes, calculated as follows:

| | Year ended 31 December | | |
|---|---|---|---|
| | **2006** | **2005** | **2004** |
| Weighted average number of ordinary shares at 31 December | 5,510,345,238 | 5,430,594,654 | 5,331,253,996 |
| Number of ordinary shares deemed to be issued for no consideration | 5,770,222 | 6,157,882 | 5,963,677 |
| Weighted average number of ordinary shares (diluted) at 31 December | 5,516,115,460 | 5,436,752,536 | 5,337,217,673 |

| | Six months ended 30 June | |
|---|---|---|
| | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Weighted average number of ordinary shares at 30 June | 5,550,144,410 | 5,484,385,261 |
| Number of ordinary shares deemed to be issued for no consideration | 5,020,933 | 6,331,809 |
| Weighted average number of ordinary shares (diluted) at 30 June | 5,555,165,343 | 5,490,717,070 |

**C** Both basic and diluted earnings per share would have been HK$0.37 (2006: HK$1.08; 2005: HK$1.13; 2004: HK$0.84) if the calculation is based on profit from underlying businesses attributable to equity shareholders, i.e. excluding increase in fair value of investment properties net of related deferred tax, adjusted as follows:

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Profit attributable to equity shareholders | 7,759 | 8,450 | 6,543 | 4,071 | 5,167 |
| Increase in fair value of investment properties | (2,178) | (2,800) | (2,486) | (2,450) | (1,478) |
| Deferred tax on change in fair value of investment properties (note 11A) | 381 | 490 | 435 | 429 | 259 |
| Profit from underlying businesses attributable to equity shareholders | 5,962 | 6,140 | 4,492 | 2,050 | 3,948 |

## 15 Segmental information

Segmental information is presented in accordance with the Group's business segments, which comprise the following:

Railway operations: The operation of an urban mass transit railway system within Hong Kong and an Airport Express serving the Hong Kong International Airport and the AsiaWorld-Expo both at Chek Lap Kok.

Station commercial and rail related businesses: Related commercial activities including letting of advertising and retail space, bandwidth services on the railway telecommunication system, railway consultancy services and rail related subsidiaries' businesses.

Property ownership, management and other businesses: Property rental, property management and, commencing from September 2006, operations relating to Ngong Ping 360.

Property developments: Property development at locations relating to the railway system.

The results of major business activities are summarised below:

| *in HK$ million* | Railway operations | Station commercial and rail related businesses | Property ownership, management and other businesses | Total railway operations and related activities | Property developments | Total |
|---|---|---|---|---|---|---|
| **Year ended 31 December 2006** | | | | | | |
| Revenue | 6,523 | 1,542 | 1,476 | 9,541 | — | 9,541 |
| Operating expenses before depreciation | (3,003) | (410) | (345) | (3,758) | — | (3,758) |
| | 3,520 | 1,132 | 1,131 | 5,783 | — | 5,783 |
| Profit on property developments | — | — | — | — | 5,817 | 5,817 |
| Operating profit before depreciation | 3,520 | 1,132 | 1,131 | 5,783 | 5,817 | 11,600 |
| Depreciation | (2,523) | (82) | (22) | (2,627) | — | (2,627) |
| | 997 | 1,050 | 1,109 | 3,156 | 5,817 | 8,973 |
| Unallocated corporate expenses | | | | | | (629) |
| Operating profit before interest and finance charges | | | | | | 8,344 |
| Interest and finance charges | | | | | | (1,398) |
| Change in fair value of investment properties | | | 2,178 | | | 2,178 |
| Share of profits less losses of non-controlled subsidiaries and associates | | | | | | 45 |
| Income tax | | | | | | (1,411) |
| Profit for the year ended 31 December 2006 | | | | | | 7,758 |
| **Assets** | | | | | | |
| Operational assets * | 76,097 | 2,503 | 22,971 | 101,571 | 825 | 102,396 |
| Assets under construction | 1,037 | 9 | 63 | 1,109 | 3,796 | 4,905 |
| Railway construction in progress | 232 | — | — | 232 | — | 232 |
| Property development in progress | — | — | — | — | 3,297 | 3,297 |
| Deferred expenditure | 395 | — | — | 395 | — | 395 |
| Prepaid land lease payments | 594 | — | — | 594 | — | 594 |
| Investments in securities | 272 | — | — | 272 | — | 272 |
| Properties held for sale | — | — | — | — | 2,018 | 2,018 |
| Loan to a property developer | — | — | — | — | 3,355 | 3,355 |
| | 78,627 | 2,512 | 23,034 | 104,173 | 13,291 | 117,464 |
| Interests in non-controlled subsidiaries | | | | | | 171 |
| Interests in associates | | | | | | 100 |
| Unallocated assets | | | | | | 2,686 |
| Total assets | | | | | | 120,421 |
| **Liabilities** | | | | | | |
| Segmented liabilities | 1,988 | 511 | 711 | 3,210 | 623 | 3,833 |
| Deferred income | 120 | — | — | 120 | 1,562 | 1,682 |
| | 2,108 | 511 | 711 | 3,330 | 2,185 | 5,515 |
| Unallocated liabilities | | | | | | 38,120 |
| Total liabilities | | | | | | 43,635 |
| **Other Information** | | | | | | |
| Capital expenditure on: | | | | | | |
| Operational assets | 64 | 4 | 470 | 538 | — | 538 |
| Assets under construction | 1,075 | 116 | 63 | 1,254 | 898 | 2,152 |
| Railway construction in progress | 430 | — | — | 430 | — | 430 |
| Property development in progress | — | — | — | — | 1,113 | 1,113 |
| Non-cash expenses other than depreciation | 37 | 11 | — | 48 | — | 48 |

As substantially all the principal operating activities of the Group were carried out in Hong Kong throughout the reporting periods, no geographical analysis is provided.

* Operational assets include property, plant and equipment and other assets employed in the operations of individual business segments.

| *in HK$ million* | Railway operations | Station commercial and rail related businesses | Property ownership, management and other businesses | Total railway operations and related activities | Property developments | Total |
|---|---|---|---|---|---|---|
| **Year ended 31 December 2005** | | | | | | |
| Revenue | 6,282 | 1,555 | 1,316 | 9,153 | — | 9,153 |
| Operating expenses before depreciation | (3,005) | (358) | (238) | (3,601) | — | (3,601) |
| | 3,277 | 1,197 | 1,078 | 5,552 | — | 5,552 |
| Profit on property developments | — | — | — | — | 6,145 | 6,145 |
| Operating profit before depreciation | 3,277 | 1,197 | 1,078 | 5,552 | 6,145 | 11,697 |
| Depreciation | (2,517) | (126) | (4) | (2,647) | — | (2,647) |
| | 760 | 1,071 | 1,074 | 2,905 | 6,145 | 9,050 |
| Unallocated corporate expenses | | | | | | (486) |
| Operating profit before interest and finance charges | | | | | | 8,564 |
| Interest and finance charges | | | | | | (1,361) |
| Change in fair value of investment properties | | | 2,800 | | | 2,800 |
| Share of profits less losses of non-controlled subsidiaries and associates | | | | | | 9 |
| Income tax | | | | | | (1,549) |
| Profit for the year ended 31 December 2005 | | | | | | 8,463 |
| **Assets** | | | | | | |
| Operational assets * | 77,697 | 1,525 | 20,243 | 99,465 | 2,042 | 101,507 |
| Assets under construction | 739 | 24 | — | 763 | 2,898 | 3,661 |
| Railway construction in progress | 1,006 | — | — | 1,006 | — | 1,006 |
| Property development in progress | — | — | — | — | 2,756 | 2,756 |
| Deferred expenditure | 209 | — | — | 209 | — | 209 |
| Prepaid land lease payments | 608 | — | — | 608 | — | 608 |
| Investments in securities | 183 | — | — | 183 | — | 183 |
| Properties held for sale | — | — | — | — | 1,311 | 1,311 |
| | 80,442 | 1,549 | 20,243 | 102,234 | 9,007 | 111,241 |
| Interests in non-controlled subsidiaries | | | | | | 103 |
| Unallocated assets | | | | | | 2,322 |
| Total assets | | | | | | 113,666 |
| **Liabilities** | | | | | | |
| Segmented liabilities | 2,173 | 373 | 499 | 3,045 | 559 | 3,604 |
| Deferred income | 126 | — | — | 126 | 3,458 | 3,584 |
| | 2,299 | 373 | 499 | 3,171 | 4,017 | 7,188 |
| Unallocated liabilities | | | | | | 36,582 |
| Total liabilities | | | | | | 43,770 |
| **Other Information** | | | | | | |
| Capital expenditure on: | | | | | | |
| Operational assets | 30 | 14 | 405 | 449 | — | 449 |
| Assets under construction | 768 | 238 | — | 1,006 | 721 | 1,727 |
| Railway construction in progress | 983 | — | — | 983 | — | 983 |
| Property development in progress | — | — | — | — | 1,455 | 1,455 |
| Non-cash expenses other than depreciation | 40 | 4 | — | 44 | — | 44 |

As substantially all the principal operating activities of the Group were carried out in Hong Kong throughout the reporting periods, no geographical analysis is provided.

* Operational assets include property, plant and equipment and other assets employed in the operations of individual business segments.

| *in HK$ million* | Railway operations | Station commercial and rail related businesses | Property ownership, management and other businesses | Total railway operations and related activities | Property developments | Total |
|---|---|---|---|---|---|---|
| **Year ended 31 December 2004** | | | | | | |
| Revenue | 5,932 | 1,311 | 1,108 | 8,351 | — | 8,351 |
| Operating expenses before depreciation | (2,906) | (315) | (207) | (3,428) | — | (3,428) |
| | 3,026 | 996 | 901 | 4,923 | — | 4,923 |
| Profit on property developments | — | — | — | — | 4,568 | 4,568 |
| Operating profit before depreciation | 3,026 | 996 | 901 | 4,923 | 4,568 | 9,491 |
| Depreciation | (2,356) | (117) | (4) | (2,477) | — | (2,477) |
| | 670 | 879 | 897 | 2,446 | 4,568 | 7,014 |
| Unallocated corporate expenses | | | | | | (416) |
| Operating profit before interest and finance charges | | | | | | 6,598 |
| Interest and finance charges | | | | | | (1,450) |
| Change in fair value of investment properties | | | 2,486 | | | 2,486 |
| Share of profit of non-controlled subsidiaries | | | | | | 39 |
| Income tax | | | | | | (1,130) |
| Profit for the year ended 31 December 2004 | | | | | | 6,543 |
| **Assets** | | | | | | |
| Operational assets * | 78,356 | 1,352 | 17,048 | 96,756 | 282 | 97,038 |
| Assets under construction | 868 | 6 | — | 874 | 2,177 | 3,051 |
| Railway construction in progress | 962 | — | — | 962 | — | 962 |
| Property development in progress | — | — | — | — | 2,088 | 2,088 |
| Deferred expenditure | 78 | — | — | 78 | — | 78 |
| Prepaid land lease payments | 621 | — | — | 621 | — | 621 |
| Investments in securities | 202 | — | — | 202 | — | 202 |
| Properties held for sale | — | — | — | — | 815 | 815 |
| | 81,087 | 1,358 | 17,048 | 99,493 | 5,362 | 104,855 |
| Interests in non-controlled subsidiaries | | | | | | 63 |
| Unallocated assets | | | | | | 1,756 |
| Total assets | | | | | | 106,674 |
| **Liabilities** | | | | | | |
| Segmented liabilities | 2,079 | 365 | 463 | 2,907 | 483 | 3,390 |
| Deferred income | 132 | — | — | 132 | 4,506 | 4,638 |
| | 2,211 | 365 | 463 | 3,039 | 4,989 | 8,028 |
| Unallocated liabilities | | | | | | 36,746 |
| Total liabilities | | | | | | 44,774 |
| **Other Information** | | | | | | |
| Capital expenditure on: | | | | | | |
| Operational assets | 43 | 6 | 32 | 81 | — | 81 |
| Assets under construction | 918 | 150 | — | 1,068 | 2,177 | 3,245 |
| Railway construction in progress | 875 | — | — | 875 | — | 875 |
| Property development in progress | — | — | — | — | 184 | 184 |
| Non-cash expenses other than depreciation | 19 | 6 | — | 25 | — | 25 |

As substantially all the principal operating activities of the Group were carried out in Hong Kong throughout the reporting periods, no geographical analysis is provided.

* Operational assets include property, plant and equipment and other assets employed in the operations of individual business segments.

| *in HK$ million* | **Railway operations** | **Station commercial and rail related businesses** | **Property ownership, management and other businesses** | **Total railway operations and related activities** | **Property developments** | **Total** |
|---|---|---|---|---|---|---|
| **Six months ended 30 June 2007 (unaudited)** | | | | | | |
| Revenue | 3,247 | 735 | 870 | 4,852 | — | 4,852 |
| Operating expenses before depreciation | (1,413) | (165) | (223) | (1,801) | — | (1,801) |
| | 1,834 | 570 | 647 | 3,051 | — | 3,051 |
| Profit on property developments | — | — | — | — | 1,664 | 1,664 |
| Operating profit before depreciation | 1,834 | 570 | 647 | 3,051 | 1,664 | 4,715 |
| Depreciation | (1,258) | (32) | (32) | (1,322) | — | (1,322) |
| | 576 | 538 | 615 | 1,729 | 1,664 | 3,393 |
| Unallocated corporate expenses | | | | | | (280) |
| Operating profit before interest and finance charges | | | | | | 3,113 |
| Interest and finance charges | | | | | | (654) |
| Change in fair value of investment properties | | | 2,450 | | | 2,450 |
| Share of profits less losses of non-controlled subsidiaries and associates | | | | | | 42 |
| Income tax | | | | | | (879) |
| Profit for the six months ended 30 June 2007 | | | | | | 4,072 |
| **Assets** | | | | | | |
| Operational assets * | 75,380 | 1,259 | 26,682 | 103,321 | 985 | 104,306 |
| Assets under construction | 815 | 5 | — | 820 | 4,030 | 4,850 |
| Railway construction in progress | 276 | — | — | 276 | — | 276 |
| Property development in progress | — | — | — | — | 3,200 | 3,200 |
| Deferred expenditure | 531 | — | — | 531 | — | 531 |
| Prepaid land lease payments | 587 | — | — | 587 | — | 587 |
| Investments in securities | 340 | — | — | 340 | — | 340 |
| Properties held for sale | — | — | — | — | 2,164 | 2,164 |
| Loan to a property developer | — | — | — | — | 3,442 | 3,442 |
| | 77,929 | 1,264 | 26,682 | 105,875 | 13,821 | 119,696 |
| Interests in non-controlled subsidiaries | | | | | | 213 |
| Interests in associates | | | | | | 203 |
| Unallocated assets | | | | | | 2,922 |
| Total assets | | | | | | 123,034 |
| **Liabilities** | | | | | | |
| Segmented liabilities | 1,760 | 368 | 872 | 3,000 | 2,685 | 5,685 |
| Deferred income | 118 | — | — | 118 | 1,108 | 1,226 |
| | 1,878 | 368 | 872 | 3,118 | 3,793 | 6,911 |
| Unallocated liabilities | | | | | | 35,826 |
| Total liabilities | | | | | | 42,737 |
| **Other Information** | | | | | | |
| Capital expenditure on: | | | | | | |
| Operational assets | 9 | — | 27 | 36 | — | 36 |
| Assets under construction | 236 | 67 | 20 | 323 | 234 | 557 |
| Railway construction in progress | 104 | — | — | 104 | — | 104 |
| Property development in progress | — | — | — | — | 125 | 125 |
| Non-cash expenses other than depreciation | 14 | — | 1 | 15 | — | 15 |

As substantially all the principal operating activities of the Group were carried out in Hong Kong throughout the reporting periods, no geographical analysis is provided.

* Operational assets include property, plant and equipment and other assets employed in the operations of individual business segments.

| *in HK$ million* | Railway operations | Station commercial and rail related businesses | Property ownership, management and other businesses | Total railway operations and related activities | Property developments | Total |
|---|---|---|---|---|---|---|
| **Six months ended 30 June 2006 (unaudited)** | | | | | | |
| Revenue | 3,138 | 735 | 693 | 4,566 | — | 4,566 |
| Operating expenses before depreciation | (1,372) | (183) | (132) | (1,687) | — | (1,687) |
| | 1,766 | 552 | 561 | 2,879 | — | 2,879 |
| Profit on property developments | — | — | — | — | 4,072 | 4,072 |
| Operating profit before depreciation | 1,766 | 552 | 561 | 2,879 | 4,072 | 6,951 |
| Depreciation | (1,244) | (47) | (2) | (1,293) | — | (1,293) |
| | 522 | 505 | 559 | 1,586 | 4,072 | 5,658 |
| Unallocated corporate expenses | | | | | | (262) |
| Operating profit before interest and finance charges | | | | | | 5,396 |
| Interest and finance charges | | | | | | (739) |
| Change in fair value of investment properties | | | 1,478 | | | 1,478 |
| Share of profits less losses of non-controlled subsidiaries and associates | | | | | | 16 |
| Income tax | | | | | | (984) |
| Profit for the six months ended 30 June 2006 | | | | | | 5,167 |
| **Assets** | | | | | | |
| Operational assets * | 76,812 | 1,413 | 21,803 | 100,028 | 2,953 | 102,981 |
| Assets under construction | 859 | 6 | 4 | 869 | 3,614 | 4,483 |
| Railway construction in progress | 1,185 | — | — | 1,185 | — | 1,185 |
| Property development in progress | — | — | — | — | 3,189 | 3,189 |
| Deferred expenditure | 325 | — | — | 325 | — | 325 |
| Prepaid land lease payments | 601 | — | — | 601 | — | 601 |
| Investments in securities | 205 | — | — | 205 | — | 205 |
| Properties held for sale | — | — | — | — | 3,364 | 3,364 |
| Loan to a property developer | — | — | — | — | 3,268 | 3,268 |
| | 79,987 | 1,419 | 21,807 | 103,213 | 16,388 | 119,601 |
| Interests in non-controlled subsidiaries | | | | | | 131 |
| Interests in associates | | | | | | 100 |
| Unallocated assets | | | | | | 2,486 |
| Total assets | | | | | | 122,318 |
| **Liabilities** | | | | | | |
| Segmented liabilities | 2,004 | 210 | 562 | 2,776 | 1,096 | 3,872 |
| Deferred income | 123 | — | — | 123 | 2,457 | 2,580 |
| | 2,127 | 210 | 562 | 2,899 | 3,553 | 6,452 |
| Unallocated liabilities | | | | | | 41,298 |
| Total liabilities | | | | | | 47,750 |
| **Other Information** | | | | | | |
| Capital expenditure on: | | | | | | |
| Operational assets | 27 | 2 | 7 | 36 | — | 36 |
| Assets under construction | 415 | 44 | 4 | 463 | 716 | 1,179 |
| Railway construction in progress | 179 | — | — | 179 | — | 179 |
| Property development in progress | — | — | — | — | 941 | 941 |
| Non-cash expenses other than depreciation | 14 | 1 | — | 15 | — | 15 |

As substantially all the principal operating activities of the Group were carried out in Hong Kong throughout the reporting periods, no geographical analysis is provided.

* Operational assets include property, plant and equipment and other assets employed in the operation of individual business segments.

## 16 Fixed assets

The Group

| *in HK$ million* | Investment properties | Self-occupied land and buildings | Civil works | Plant and equipment | Assets under construction | Total |
|---|---|---|---|---|---|---|
| Cost or Valuation | | | | | | |
| At 1 January 2006 | 19,892 | 1,705 | 46,188 | 56,339 | 3,661 | 127,785 |
| Additions | 469 | — | — | 69 | 2,152 | 2,690 |
| Disposals/Write-offs | — | — | (20) | (370) | (2) | (392) |
| Change in fair value | 2,178 | — | — | — | — | 2,178 |
| Surplus on revaluation (note 40) | — | 284 | — | — | — | 284 |
| Tung Chung Cable Car Project commissioned (note 17) | — | — | 375 | 824 | — | 1,199 |
| Other assets commissioned | — | — | 1 | 905 | (906) | — |
| At 31 December 2006 | 22,539 | 1,989 | 46,544 | 57,767 | 4,905 | 133,744 |
| At Cost | — | — | 46,544 | 57,767 | 4,905 | 109,216 |
| At 31 December 2006 Valuation | 22,539 | 1,989 | — | — | — | 24,528 |
| Aggregate depreciation | | | | | | |
| At 1 January 2006 | — | — | 3,492 | 21,018 | — | 24,510 |
| Charge for the year | — | 45 | 380 | 2,249 | — | 2,674 |
| Written back on disposal | — | — | (8) | (330) | — | (338) |
| Written back on revaluation (note 40) | — | (45) | — | — | — | (45) |
| At 31 December 2006 | — | — | 3,864 | 22,937 | — | 26,801 |
| **Net book value at 31 December 2006** | 22,539 | 1,989 | 42,680 | 34,830 | 4,905 | 106,943 |

The Group

| *in HK$ million* | **Investment properties** | **Self-occupied land and buildings** | **Civil works** | **Plant and equipment** | **Assets under construction** | **Total** |
|---|---|---|---|---|---|---|
| Cost or Valuation | | | | | | |
| At 1 January 2005 | 16,687 | 1,246 | 45,704 | 55,081 | 3,051 | 121,769 |
| Additions | 405 | — | — | 44 | 1,727 | 2,176 |
| Capitalisation adjustments * | — | — | (2) | (76) | — | (78) |
| Disposals/Write-offs | — | — | (2) | (275) | (3) | (280) |
| Change in fair value | 2,800 | — | — | — | — | 2,800 |
| Surplus on revaluation (note 40) | — | 459 | — | — | — | 459 |
| Reclassification | — | — | 175 | (175) | — | — |
| Disneyland Resort Line and AsiaWorld-Expo Station Projects commissioned (note 17) | — | — | 176 | 763 | — | 939 |
| Other assets commissioned | — | — | 137 | 977 | (1,114) | — |
| At 31 December 2005 | 19,892 | 1,705 | 46,188 | 56,339 | 3,661 | 127,785 |
| At Cost | — | — | 46,188 | 56,339 | 3,661 | 106,188 |
| At 31 December 2005 Valuation | 19,892 | 1,705 | — | — | — | 21,597 |
| Aggregate depreciation | | | | | | |
| At 1 January 2005 | — | — | 3,093 | 18,984 | — | 22,077 |
| Charge for the year | — | 33 | 395 | 2,258 | — | 2,686 |
| Capitalisation adjustments * | — | — | — | (4) | — | (4) |
| Written back on disposal | — | — | (1) | (215) | — | (216) |
| Written back on revaluation (note 40) | — | (33) | — | — | — | (33) |
| Reclassification | — | — | 5 | (5) | — | — |
| At 31 December 2005 | — | — | 3,492 | 21,018 | — | 24,510 |
| **Net book value at 31 December 2005** | 19,892 | 1,705 | 42,696 | 35,321 | 3,661 | 103,275 |

* Capitalisation adjustments relate to certain railway assets capitalised at time of commissioning based on contractors' claimed values. Such assets' final values have been adjusted downward following finalisation of contract claims with contractors at lower final contract values during the year.

The Group

| *in HK$ million* | **Investment properties** | **Self-occupied land and buildings** | **Civil works** | **Plant and equipment** | **Assets under construction** | **Total** |
|---|---|---|---|---|---|---|
| Cost or Valuation | | | | | | |
| At 1 January 2004 | 14,169 | 866 | 45,740 | 54,319 | 940 | 116,034 |
| Additions | 32 | — | — | 49 | 3,245 | 3,326 |
| Capitalisation adjustments * | — | — | (124) | (156) | — | (280) |
| Disposals/Write-offs | — | — | (1) | (172) | (4) | (177) |
| Change in fair value | 2,486 | — | — | — | — | 2,486 |
| Surplus on revaluation (note 40) | — | 311 | — | — | — | 311 |
| Write back of revaluation deficit (note 5D) | — | 69 | — | — | — | 69 |
| Reclassification | — | — | 82 | (82) | — | — |
| Assets commissioned | — | — | 7 | 1,123 | (1,130) | — |
| At 31 December 2004 | 16,687 | 1,246 | 45,704 | 55,081 | 3,051 | 121,769 |
| At Cost | — | — | 45,704 | 55,081 | 3,051 | 103,836 |
| At 31 December 2004 Valuation | 16,687 | 1,246 | — | — | — | 17,933 |
| Aggregate depreciation | | | | | | |
| At 1 January 2004 | — | — | 2,705 | 17,042 | — | 19,747 |
| Charge for the year | — | 20 | 392 | 2,107 | — | 2,519 |
| Capitalisation adjustments * | — | — | (3) | (17) | — | (20) |
| Written back on disposal | — | — | (1) | (148) | — | (149) |
| Written back on revaluation (note 40) | — | (20) | — | — | — | (20) |
| Reclassification | — | — | — | — | — | — |
| At 31 December 2004 | — | — | 3,093 | 18,984 | — | 22,077 |
| **Net book value at 31 December 2004** | 16,687 | 1,246 | 42,611 | 36,097 | 3,051 | 99,692 |

* Capitalisation adjustments relate to certain railway assets capitalised at time of commissioning based on contractors' claimed values. Such assets' final values have been adjusted downward following finalisation of contract claims with contractors at lower final contract values during the year.

The Group

| *in HK$ million* | **Investment properties** | **Self-occupied land and buildings** | **Civil works** | **Plant and equipment** | **Assets under construction** | **Total** |
|---|---|---|---|---|---|---|
| Cost or Valuation (unaudited) | | | | | | |
| At 1 January 2007 | 22,539 | 1,989 | 46,544 | 57,767 | 4,905 | 133,744 |
| Additions | 24 | — | — | 12 | 557 | 593 |
| Disposals/Write-offs | — | — | — | (120) | — | (120) |
| Change in fair value | 2,450 | — | — | — | — | 2,450 |
| Surplus on revaluation (note 40) | — | 120 | — | — | — | 120 |
| Reclassification | — | — | (45) | 45 | — | — |
| SkyPlaza Platform Project commissioned (note 17) | — | — | — | 60 | — | 60 |
| Other assets commissioned | — | — | 16 | 596 | (612) | — |
| At 30 June 2007 | 25,013 | 2,109 | 46,515 | 58,360 | 4,850 | 136,847 |
| At Cost | — | — | 46,515 | 58,360 | 4,850 | 109,725 |
| At 30 June 2007 Valuation | 25,013 | 2,109 | — | — | — | 27,122 |
| Aggregate depreciation (unaudited) | | | | | | |
| At 1 January 2007 | — | — | 3,864 | 22,937 | — | 26,801 |
| Charge for the period | — | 25 | 199 | 1,124 | — | 1,348 |
| Written back on disposal | — | — | — | (102) | — | (102) |
| Written back on revaluation (note 40) | — | (25) | — | — | — | (25) |
| Reclassification | — | — | (19) | 19 | — | — |
| At 30 June 2007 | — | — | 4,044 | 23,978 | — | 28,022 |
| **Net book value at 30 June 2007 (unaudited)** | 25,013 | 2,109 | 42,471 | 34,382 | 4,850 | 108,825 |

The Group

| *in HK$ million* | **Investment properties** | **Self-occupied land and buildings** | **Civil works** | **Plant and equipment** | **Assets under construction** | **Total** |
|---|---|---|---|---|---|---|
| Cost or Valuation (unaudited) | | | | | | |
| At 1 January 2006 | 19,892 | 1,705 | 46,188 | 56,339 | 3,661 | 127,785 |
| Additions | 7 | — | 5 | 24 | 1,179 | 1,215 |
| Disposals/Write-offs | — | — | (2) | (33) | (1) | (36) |
| Change in fair value | 1,478 | — | — | — | — | 1,478 |
| Surplus on revaluation (note 40) | — | 272 | — | — | — | 272 |
| Assets commissioned | — | — | 1 | 355 | (356) | — |
| At 30 June 2006 | 21,377 | 1,977 | 46,192 | 56,685 | 4,483 | 130,714 |
| At Cost | — | — | 46,192 | 56,685 | 4,483 | 107,360 |
| At 30 June 2006 Valuation | 21,377 | 1,977 | — | — | — | 23,354 |
| Aggregate depreciation (unaudited) | | | | | | |
| At 1 January 2006 | — | — | 3,492 | 21,018 | — | 24,510 |
| Charge for the period | — | 21 | 198 | 1,096 | — | 1,315 |
| Written back on disposal | — | — | (1) | (16) | — | (17) |
| Written back on revaluation (note 40) | — | (21) | — | — | — | (21) |
| At 30 June 2006 | — | — | 3,689 | 22,098 | — | 25,787 |
| **Net book value at 30 June 2006 (unaudited)** | 21,377 | 1,977 | 42,503 | 34,587 | 4,483 | 104,927 |

The Company

| *in HK$ million* | **Investment properties** | **Self-occupied land and buildings** | **Civil works** | **Plant and equipment** | **Assets under construction** | **Total** |
|---|---|---|---|---|---|---|
| Cost or Valuation | | | | | | |
| At 1 January 2006 | 19,892 | 1,705 | 46,188 | 55,676 | 3,637 | 127,098 |
| Additions | 469 | — | — | 65 | 2,069 | 2,603 |
| Disposals/Write-offs | — | — | (20) | (241) | (2) | (263) |
| Change in fair value | 2,178 | — | — | — | — | 2,178 |
| Surplus on revaluation (note 40) | — | 284 | — | — | — | 284 |
| Tung Chung Cable Car Project commissioned (note 17) | — | — | 375 | 824 | — | 1,199 |
| Other assets commissioned | — | — | 1 | 871 | (872) | — |
| At 31 December 2006 | 22,539 | 1,989 | 46,544 | 57,195 | 4,832 | 133,099 |
| At Cost | — | — | 46,544 | 57,195 | 4,832 | 108,571 |
| At 31 December 2006 Valuation | 22,539 | 1,989 | — | — | — | 24,528 |
| Aggregate depreciation | | | | | | |
| At 1 January 2006 | — | — | 3,492 | 20,428 | — | 23,920 |
| Charge for the year | — | 45 | 380 | 2,216 | — | 2,641 |
| Written back on disposal | — | — | (8) | (204) | — | (212) |
| Written back on revaluation (note 40) | — | (45) | — | — | — | (45) |
| At 31 December 2006 | — | — | 3,864 | 22,440 | — | 26,304 |
| **Net book value at 31 December 2006** | 22,539 | 1,989 | 42,680 | 34,755 | 4,832 | 106,795 |

The Company

| *in HK$ million* | **Investment properties** | **Self-occupied land and buildings** | **Civil works** | **Plant and equipment** | **Assets under construction** | **Total** |
|---|---|---|---|---|---|---|
| Cost or Valuation | | | | | | |
| At 1 January 2005 | 16,687 | 1,246 | 45,704 | 54,414 | 3,045 | 121,096 |
| Additions | 405 | — | — | 30 | 1,709 | 2,144 |
| Capitalisation adjustments * | — | — | (2) | (76) | — | (78) |
| Disposals/Write-offs | — | — | (2) | (257) | (3) | (262) |
| Change in fair value | 2,800 | — | — | — | — | 2,800 |
| Surplus on revaluation (note 40) | — | 459 | — | — | — | 459 |
| Reclassification | — | — | 175 | (175) | — | — |
| Disneyland Resort Line and AsiaWorld-Expo Station Projects commissioned (note 17) | — | — | 176 | 763 | — | 939 |
| Other assets commissioned | — | — | 137 | 977 | (1,114) | — |
| At 31 December 2005 | 19,892 | 1,705 | 46,188 | 55,676 | 3,637 | 127,098 |
| At Cost | — | — | 46,188 | 55,676 | 3,637 | 105,501 |
| At 31 December 2005 Valuation | 19,892 | 1,705 | — | — | — | 21,597 |
| Aggregate depreciation | | | | | | |
| At 1 January 2005 | — | — | 3,093 | 18,471 | — | 21,564 |
| Charge for the year | — | 33 | 395 | 2,180 | — | 2,608 |
| Capitalisation adjustments * | — | — | — | (4) | — | (4) |
| Written back on disposal | — | — | (1) | (214) | — | (215) |
| Written back on revaluation (note 40) | — | (33) | — | — | — | (33) |
| Reclassification | — | — | 5 | (5) | — | — |
| At 31 December 2005 | — | — | 3,492 | 20,428 | — | 23,920 |
| **Net book value at 31 December 2005** | 19,892 | 1,705 | 42,696 | 35,248 | 3,637 | 103,178 |

* Capitalisation adjustments relate to certain railway assets capitalised at time of commissioning based on contractors' claimed values. Such assets' final values have been adjusted downward following finalisation of contract claims with contractors at lower final contract values during the year.

The Company

| *in HK$ million* | **Investment properties** | **Self-occupied land and buildings** | **Civil works** | **Plant and equipment** | **Assets under construction** | **Total** |
|---|---|---|---|---|---|---|
| Cost or Valuation | | | | | | |
| At 1 January 2004 | 14,169 | 866 | 45,740 | 53,693 | 922 | 115,390 |
| Additions | 32 | — | — | 43 | 3,222 | 3,297 |
| Capitalisation adjustments * | — | — | (124) | (156) | — | (280) |
| Disposals/Write-offs | — | — | (1) | (172) | (4) | (177) |
| Change in fair value | 2,486 | — | — | — | — | 2,486 |
| Surplus on revaluation (note 40) | — | 311 | — | — | — | 311 |
| Write back of revaluation deficit | — | 69 | — | — | — | 69 |
| Reclassification | — | — | 82 | (82) | — | — |
| Assets commissioned | — | — | 7 | 1,088 | (1,095) | — |
| At 31 December 2004 | 16,687 | 1,246 | 45,704 | 54,414 | 3,045 | 121,096 |
| At Cost | — | — | 45,704 | 54,414 | 3,045 | 103,163 |
| At 31 December 2004 Valuation | 16,687 | 1,246 | — | — | — | 17,933 |
| Aggregate depreciation | | | | | | |
| At 1 January 2004 | — | — | 2,705 | 16,597 | — | 19,302 |
| Charge for the year | — | 20 | 392 | 2,039 | — | 2,451 |
| Capitalisation adjustments * | — | — | (3) | (17) | — | (20) |
| Written back on disposal | — | — | (1) | (148) | — | (149) |
| Written back on revaluation (note 40) | — | (20) | — | — | — | (20) |
| Reclassification | — | — | — | — | — | — |
| At 31 December 2004 | — | — | 3,093 | 18,471 | — | 21,564 |
| **Net book value at 31 December 2004** | 16,687 | 1,246 | 42,611 | 35,943 | 3,045 | 99,532 |

* Capitalisation adjustments relate to certain railway assets capitalised at time of commissioning based on contractors' claimed values. Such assets' final values have been adjusted downward following finalisation of contract claims with contractors at lower final contract values during the year.

The Company

| *in HK$ million* | **Investment properties** | **Self-occupied land and buildings** | **Civil works** | **Plant and equipment** | **Assets under construction** | **Total** |
|---|---|---|---|---|---|---|
| Cost or Valuation (unaudited) | | | | | | |
| At 1 January 2007 | 22,539 | 1,989 | 46,544 | 57,195 | 4,832 | 133,099 |
| Additions | 24 | — | — | 12 | 535 | 571 |
| Disposals/Write-offs | — | — | — | (113) | — | (113) |
| Change in fair value | 2,450 | — | — | — | — | 2,450 |
| Surplus on revaluation (note 40) | — | 120 | — | — | — | 120 |
| Reclassification | — | — | (45) | 45 | — | — |
| SkyPlaza Platform Project commissioned (note 17) | — | — | — | 60 | — | 60 |
| Other assets commissioned | — | — | 16 | 506 | (522) | — |
| At 30 June 2007 | 25,013 | 2,109 | 46,515 | 57,705 | 4,845 | 136,187 |
| At Cost | — | — | 46,515 | 57,705 | 4,845 | 109,065 |
| At 30 June 2007 Valuation | 25,013 | 2,109 | — | — | — | 27,122 |
| Aggregate depreciation (unaudited) | | | | | | |
| At 1 January 2007 | — | — | 3,864 | 22,440 | — | 26,304 |
| Charge for the period | — | 25 | 199 | 1,116 | — | 1,340 |
| Written back on disposal | — | — | — | (99) | — | (99) |
| Written back on revaluation (note 40) | — | (25) | — | — | — | (25) |
| Reclassification | — | — | (19) | 19 | — | — |
| At 30 June 2007 | — | — | 4,044 | 23,476 | — | 27,520 |
| **Net book value at 30 June 2007 (unaudited)** | 25,013 | 2,109 | 42,471 | 34,229 | 4,845 | 108,667 |

The Company

| *in HK$ million* | **Investment properties** | **Self-occupied land and buildings** | **Civil works** | **Plant and equipment** | **Assets under construction** | **Total** |
|---|---|---|---|---|---|---|
| Cost or Valuation (unaudited) | | | | | | |
| At 1 January 2006 | 19,892 | 1,705 | 46,188 | 55,676 | 3,637 | 127,098 |
| Additions | 7 | — | 5 | 22 | 1,163 | 1,197 |
| Disposals/Write-offs | — | — | (2) | (33) | (1) | (36) |
| Change in fair value | 1,478 | — | — | — | — | 1,478 |
| Surplus on revaluation (note 40) | — | 272 | — | — | — | 272 |
| Assets commissioned | — | — | 1 | 325 | (326) | — |
| At 30 June 2006 | 21,377 | 1,977 | 46,192 | 55,990 | 4,473 | 130,009 |
| At Cost | — | — | 46,192 | 55,990 | 4,473 | 106,655 |
| At 30 June 2006 Valuation | 21,377 | 1,977 | — | — | — | 23,354 |
| Aggregate depreciation (unaudited) | | | | | | |
| At 1 January 2006 | — | — | 3,492 | 20,428 | — | 23,920 |
| Charge for the period | — | 21 | 198 | 1,073 | — | 1,292 |
| Written back on disposal | — | — | (1) | (16) | — | (17) |
| Written back on revaluation (note 40) | — | (21) | — | — | — | (21) |
| At 30 June 2006 | — | — | 3,689 | 21,485 | — | 25,174 |
| **Net book value at 30 June 2006 (unaudited)** | 21,377 | 1,977 | 42,503 | 34,505 | 4,473 | 104,835 |

*A* The analysis of the Group's properties, all of which are held in Hong Kong and carried at fair value, is as follows:

The Group and The Company

| | Investment properties | | | | |
|---|---|---|---|---|---|
| | At 31 December | | | At 30 June | |
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Long leases | 1,437 | 1,399 | 1,431 | 1,439 | 1,414 |
| Medium-term leases | 21,102 | 18,493 | 15,256 | 23,574 | 19,963 |
| | 22,539 | 19,892 | 16,687 | 25,013 | 21,377 |

| | Self-occupied land and buildings | | | | |
|---|---|---|---|---|---|
| | At 31 December | | | At 30 June | |
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Medium-term leases | 1,989 | 1,705 | 1,246 | 2,109 | 1,977 |
| | 1,989 | 1,705 | 1,246 | 2,109 | 1,977 |

*B* All investment properties of the Group were revalued at open market value at 30 June 2007 by an independent firm of surveyors, DTZ Debenham Tie Leung, who have among their staff Members of the Hong Kong Institute of Surveyors. The valuations are based on a "term and reversion basis", which capitalises the existing and reversionary net rental income having regard to market valuation checks on comparable sale and yields. The net increase in fair value for the six months ended 30 June 2007 of HK$2,450 million (2006: HK$2,178 million; 2005: HK$2,800 million; 2004: HK$2,486 million) arising from the revaluation has been credited to the profit and loss account.

*C* All self-occupied land and buildings were revalued at open market value on an existing use basis at 30 June 2007 by an independent firm of surveyors, DTZ Debenham Tie Leung, who have among their staff Members of the Hong Kong Institute of Surveyors. The valuation resulted in a net revaluation surplus of HK$145 million (2006: HK$329 million; 2005: HK$492 million; 2004: HK$400 million). The net revaluation surplus of HK$145 million (2006: HK$329 million; 2005: HK$492 million; 2004: HK$331 million, excluding HK$69 million, which was credited to the profit and loss account in respect of deficit previously recognised for the same property (note 5D)), net of deferred tax of HK$25 million (2006: HK$58 million; 2005: HK$86 million; 2004: HK$58 million) (note 38B), has been transferred to the fixed asset revaluation reserve account (note 40).

The carrying amount of the self-occupied land and buildings at 30 June 2007 would have been HK$880 million (2006: HK$892 million; 2005: HK$914 million; 2004: HK$936 million) had the land and buildings been stated at cost less accumulated depreciation.

*D* Assets under construction include a partially renovated shell of the retail shopping centre at Union Square, Kowloon Station and its car parking spaces received by the Company as a sharing in kind from the development. The properties under construction are stated at cost, which is deemed to be the fair value upon receipt (note 2J(ix)) determined by reference to an open market valuation undertaken by an independent firm of surveyors, Jones Lang LaSalle, who have among their staff Members of the Hong Kong Institute of Surveyors.

*E* In addition to the self-occupied land and buildings treated as being held under finance leases in note 16A above, the Group has the following assets held under agreements which are treated as finance leases:

The Group and The Company

| | Civil works Eastern Harbour Crossing | | | | |
|---|---|---|---|---|---|
| | At 31 December | | | At 30 June | |
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Cost | 1,254 | 1,254 | 1,254 | 1,254 | 1,254 |
| Less: Aggregate depreciation | 307 | 288 | 269 | 317 | 297 |
| Net book value | 947 | 966 | 985 | 937 | 957 |

The Company has entered into a Management Agreement (the "Agreement") with New Hong Kong Tunnel Company Limited to operate the Eastern Harbour Crossing until 2008. Included in the assets held under the Agreement are railway and ancillary works relating to the rail tunnel.

At the expiry of the Agreement, title to the assets will, pursuant to the Eastern Harbour Crossing Ordinance, be vested in the Government which has in turn entered into a Memorandum of Understanding dated 17 October 1986 with the Company to the effect that the assets will be vested in the Company on terms to be agreed between the Company and the Government. On 30 June 2000, the Company entered into a further agreement with the Government pursuant to which the relevant assets will be vested by the Government into the Company in 2008 for a nominal consideration and the Company agreed to indemnify the Government for certain amounts which are expected to be nominal. On this basis, the semi-annual payments made by the Company to New Hong Kong Tunnel Company Limited in respect of the Eastern Harbour Crossing are dealt with in these accounts as payments under a finance lease.

The Group's total non-cancellable future minimum lease payments payable to New Hong Kong Tunnel Company Limited are set out in note 33C.

*F* The Group leases out investment properties and station kiosks under operating leases. The leases typically run for an initial period of one to ten years, with an option to renew the lease after that date at which time all terms will be renegotiated. Lease payments are usually adjusted annually to reflect market rentals. Certain leases carry additional rental based on turnover. Lease incentives granted are amortised in the profit and loss account as an integral part of the net lease payment receivable.

The gross carrying amounts of investment properties of the Group and the Company held for use in operating leases were HK$25,013 million (2006: HK$22,539 million; 2005: HK$19,892 million; 2004: HK$16,687 million). The gross carrying amounts of station kiosks held for use in operating leases were HK$453 million (2006: HK$439 million; 2005: HK$446 million; 2004: HK$416 million) and the related accumulated depreciation charges were HK$119 million (2006: HK$108 million; 2005: HK$95 million; 2004: HK$80 million).

The Group's total future minimum lease receipts under non-cancellable operating leases are receivable as follows:

The Group and The Company

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Within 1 year | 1,350 | 1,295 | 1,156 | 1,319 | 1,406 |
| After 1 year but within 5 years | 1,875 | 2,025 | 1,742 | 1,854 | 1,820 |
| Later than 5 years | 161 | 214 | 332 | 127 | 171 |
| | 3,386 | 3,534 | 3,230 | 3,300 | 3,397 |

***G*** In March 2003, the Group entered into a series of structured transactions with unrelated third parties to lease out and lease back certain of its passenger cars ("Lease Transaction") involving a total original cost of HK$2,562 million and a total net book value of HK$1,674 million as at 31 March 2003. Under the Lease Transaction, the Group has leased the assets to institutional investors in the United States (the "Investors"), who have prepaid all the rentals in relation to the lease agreement. Simultaneously, the Group has leased the assets back from the Investors with an obligation to pay rentals in accordance with a pre-determined payment schedule. The Group has an option to purchase the Investors' leasehold interest in the assets at pre-determined dates for fixed amounts. Part of the rental prepayments received from the Investors has been invested in debt securities to meet the Group's rental obligations and the amount payable for exercising the purchase option under the Lease Transaction. In addition, the Group retains legal title to the assets and there are no restrictions on these assets in the operation of the railway business.

As a result of the Lease Transaction, the Group received total cash of approximately HK$3,688 million and committed to long-term lease payments with an estimated net present value in March 2003 of approximately HK$3,533 million, which have been defeased by purchase of debt securities to meet the payment obligations. The Group received in 2003 the cash amount of HK$141 million net of costs from the Lease Transaction.

As the Group is not able to control the investment account in pursuit of its own objectives and its obligations to pay the lease payments are funded by the proceeds of the above investments, those liabilities and investments in debt securities are not recognised in March 2003 as obligations and assets of the Group. The net amount of cash received by the Group has been accounted for as deferred income and is being amortised to the Group's profit and loss account over the terms of the respective leases.

## 17 Railway construction in progress

The Group and The Company

| *in HK$ million* | Balance at 1 January | Transferred from deferred expenditure (note 19) | Expenditure | Costs written off to profit and loss account (note 5C) | Capitalised on commissioning (note 16) | Transfer to stores and spares | Balance at 31 December |
|---|---|---|---|---|---|---|---|
| **31 December 2006** | | | | | | | |
| **Tseung Kwan O South Station Project** | | | | | | | |
| Construction costs | 18 | — | 99 | — | — | — | 117 |
| Consultancy fees | 8 | — | 2 | — | — | — | 10 |
| Staff costs and other expenses | 16 | — | 27 | — | — | — | 43 |
| Finance costs | 1 | — | 4 | — | — | — | 5 |
| | 43 | — | 132 | — | — | — | 175 |
| **Tung Chung Cable Car Project** | | | | | | | |
| Construction costs | 755 | — | 193 | — | (943) | (5) | — |
| Consultancy fees | 51 | — | 24 | — | (75) | — | — |
| Staff costs and other expenses | 79 | — | 15 | — | (94) | — | — |
| Finance costs | 48 | — | 39 | — | (87) | — | — |
| | 933 | — | 271 | — | (1,199) | (5) | — |
| **SkyPlaza Platform Project** | | | | | | | |
| Construction costs | 24 | — | 16 | — | — | — | 40 |
| Staff costs and other expenses | 6 | — | 8 | — | — | — | 14 |
| Finance costs | — | — | 3 | — | — | — | 3 |
| | 30 | — | 27 | — | — | — | 57 |
| **Total** | 1,006 | — | 430 | — | (1,199) | (5) | 232 |

The Group and The Company

| *in HK$ million* | Balance at 1 January | Transferred from deferred expenditure (note 19) | Expenditure | Costs written off to profit and loss account (note 5C) | Capitalised on commissioning (note 16) | Transfer to stores and spares | Balance at 31 December |
|---|---|---|---|---|---|---|---|
| **31 December 2005** | | | | | | | |
| **Tseung Kwan O South Station Project** | | | | | | | |
| Construction costs | 1 | — | 17 | — | — | — | 18 |
| Consultancy fees | 1 | — | 7 | — | — | — | 8 |
| Staff costs and other expenses | 5 | — | 11 | — | — | — | 16 |
| Finance costs | — | — | 1 | — | — | — | 1 |
| | 7 | — | 36 | — | — | — | 43 |
| **Disneyland Resort Line Project** | | | | | | | |
| Construction costs | 1,074 | — | 185 | — | (1,259) | — | — |
| Consultancy fees | 46 | — | 5 | — | (51) | — | — |
| Staff costs and other expenses | 279 | — | 74 | — | (353) | — | — |
| Finance costs | 10 | — | 14 | — | (24) | — | — |
| | 1,409 | — | 278 | — | (1,687) | — | — |
| Government grant (note 45E) | (931) | — | — | — | 931 | — | — |
| | 478 | — | 278 | — | (756) | — | — |
| **Tung Chung Cable Car Project** | | | | | | | |
| Construction costs | 336 | — | 419 | — | — | — | 755 |
| Consultancy fees | 37 | — | 14 | — | — | — | 51 |
| Staff costs and other expenses | 57 | — | 22 | — | — | — | 79 |
| Finance costs | 14 | — | 34 | — | — | — | 48 |
| | 444 | — | 489 | — | — | — | 933 |
| **AsiaWorld-Expo Station Project** | | | | | | | |
| Construction costs | 16 | — | 124 | — | (140) | — | — |
| Staff costs and other expenses | 16 | — | 23 | — | (39) | — | — |
| Finance costs | 1 | — | 3 | — | (4) | — | — |
| | 33 | — | 150 | — | (183) | — | — |
| **SkyPlaza Platform Project** | | | | | | | |
| Construction costs | — | — | 24 | — | — | — | 24 |
| Staff costs and other expenses | — | — | 6 | — | — | — | 6 |
| Finance costs | — | — | — | — | — | — | — |
| | — | — | 30 | — | — | — | 30 |
| **Total** | 962 | — | 983 | — | (939) | — | 1,006 |

The Group and The Company

| *in HK$ million* | Balance at 1 January | Transferred from deferred expenditure (note 19) | Expenditure/ (Government grant) | Costs written off to profit and loss account (note 5C) | Capitalised on commissioning (note 16) | Transfer to stores and spares | Balance at 31 December |
|---|---|---|---|---|---|---|---|
| **31 December 2004** | | | | | | | |
| **Tseung Kwan O South Station Project** | | | | | | | |
| Construction costs | 1 | — | — | — | — | — | 1 |
| Consultancy fees | 23 | — | 7 | (29) | — | — | 1 |
| Staff costs and other expenses | 16 | — | 5 | (16) | — | — | 5 |
| Finance costs | 4 | — | — | (4) | — | — | — |
| | 44 | — | 12 | (49) | — | — | 7 |
| **Disneyland Resort Line Project** | | | | | | | |
| Construction costs | 645 | — | 429 | — | — | — | 1,074 |
| Consultancy fees | 41 | — | 5 | — | — | — | 46 |
| Staff costs and other expenses | 194 | — | 85 | — | — | — | 279 |
| Finance costs | 3 | — | 7 | — | — | — | 10 |
| | 883 | — | 526 | — | — | — | 1,409 |
| Government grant (notes 45E and 45L) | (883) | — | (48) | — | — | — | (931) |
| | — | — | 478 | — | — | — | 478 |
| **Tung Chung Cable Car Project** | | | | | | | |
| Construction costs | 82 | — | 254 | — | — | — | 336 |
| Consultancy fees | 24 | — | 13 | — | — | — | 37 |
| Staff costs and other expenses | 29 | — | 28 | — | — | — | 57 |
| Finance costs | 2 | — | 12 | — | — | — | 14 |
| | 137 | — | 307 | — | — | — | 444 |
| **AsiaWorld-Expo Station Project** | | | | | | | |
| Construction costs | — | — | 16 | — | — | — | 16 |
| Staff costs and other expenses | — | 3 | 13 | — | — | — | 16 |
| Finance costs | — | — | 1 | — | — | — | 1 |
| | — | 3 | 30 | — | — | — | 33 |
| **Total** | 181 | 3 | 827 | (49) | — | — | 962 |

The Group and The Company

| *in HK$ million* | Balance at 1 January | Transferred from deferred expenditure (note 19) | Expenditure | Costs written off to profit and loss account (note 5C) | Capitalised on commissioning (note 16) | Transfer to stores and spares | Balance at 30 June |
|---|---|---|---|---|---|---|---|
| **30 June 2007 (unaudited)** | | | | | | | |
| **Tseung Kwan O South Station Project** | | | | | | | |
| Construction costs | 117 | — | 79 | — | — | — | 196 |
| Consultancy fees | 10 | — | — | — | — | — | 10 |
| Staff costs and other expenses | 43 | — | 16 | — | — | — | 59 |
| Finance costs | 5 | — | 6 | — | — | — | 11 |
| | 175 | — | 101 | — | — | — | 276 |
| **SkyPlaza Platform Project** | | | | | | | |
| Construction costs | 40 | — | 2 | — | (42) | — | — |
| Staff costs and other expenses | 14 | — | 1 | — | (15) | — | — |
| Finance costs | 3 | — | — | — | (3) | — | — |
| | 57 | — | 3 | — | (60) | — | — |
| **Total** | 232 | — | 104 | — | (60) | — | 276 |
| **30 June 2006 (unaudited)** | | | | | | | |
| **Tseung Kwan O South Station Project** | | | | | | | |
| Construction costs | 18 | — | 15 | — | — | — | 33 |
| Consultancy fees | 8 | — | — | — | — | — | 8 |
| Staff costs and other expenses | 16 | — | 10 | — | — | — | 26 |
| Finance costs | 1 | — | 2 | — | — | — | 3 |
| | 43 | — | 27 | — | — | — | 70 |
| **Tung Chung Cable Car Project** | | | | | | | |
| Construction costs | 755 | — | 82 | — | — | — | 837 |
| Consultancy fees | 51 | — | 18 | — | — | — | 69 |
| Staff costs and other expenses | 79 | — | 8 | — | — | — | 87 |
| Finance costs | 48 | — | 26 | — | — | — | 74 |
| | 933 | — | 134 | — | — | — | 1,067 |
| **SkyPlaza Platform Project** | | | | | | | |
| Construction costs | 24 | — | 12 | — | — | — | 36 |
| Staff costs and other expenses | 6 | — | 5 | — | — | — | 11 |
| Finance costs | — | — | 1 | — | — | — | 1 |
| | 30 | — | 18 | — | — | — | 48 |
| **Total** | 1,006 | — | 179 | — | — | — | 1,185 |

***A Tseung Kwan O South Station Project***

The construction of future railway stations along the Tseung Kwan O Line is covered by the Project Agreement with the Government signed on 4 November 1998.

The project is under construction with target completion date in 2009. The capital cost for the project based on the defined scope of works and programme is estimated at approximately HK$1 billion.

As at 30 June 2007, the Company had incurred expenditure of HK$276 million (2006: HK$175 million; 2005: HK$43 million; 2004: HK$7 million) on the project and had authorised outstanding commitments on contracts totalling HK$253 million (2006: HK$321 million; 2005: HK$12 million; 2004: nil) related to the project.

***B Disneyland Resort Line Project***

The Project Agreement between the Government and the Company for the design, construction, financing and operation of the Disneyland Resort Line was signed on 24 July 2002.

The project was completed on schedule and service commenced to the public on 1 August 2005. Although the final accounts of a few contracts are under negotiation with the contractors, it is anticipated that the total cost estimate of the project will be finalised within the original budget of approximately HK$2 billion (before deducting Government grant of HK$931 million).

***C Tung Chung Cable Car Project***

The Project Agreement between the Government and the Company for the design, construction, financing and operation of the Tung Chung Cable Car Project was signed on 19 November 2003.

The project was completed in mid 2006 and started to serve the public on 18 September 2006. Negotiation on the final accounts with various contractors is in progress. It is estimated that the total cost of the project will be approximately HK$1.2 billion.

***D AsiaWorld-Expo Station Project***

The Project Agreement between the Hong Kong IEC Limited and the Company for the design, construction, financing and operation of the AsiaWorld-Expo Station Project was signed on 17 March 2004.

The project met the completion target and started to serve the public on 20 December 2005. Negotiation on the final accounts with various contractors is being performed. It is anticipated that the total cost estimate of the project will be approximately the same as the original budget of approximately HK$0.2 billion.

***E SkyPlaza Platform Project***

The Project Agreement between Airport Authority and the Company for the design, construction, financing and operation of the SkyPlaza Platform Project was signed on 18 July 2005.

The project was completed and started to serve the public on 28 February 2007. Negotiation on the final accounts with various contractors is being performed. It is anticipated that the total cost estimate of the project will be approximately HK$0.1 billion.

## 18 Property development in progress

Under the Airport Railway Agreement related to the construction of the Airport Railway, the Government had granted to the Company development rights on the land ("Land Grant") over the five station sites along the railway at market value for property development. In preparing the sites for development, the Company incurs costs related to foundation and site enabling works and expects the costs to be reimbursed by property developers in the form of up-front cash payments when development packages are awarded. In accordance with the development agreements entered into with property developers, the developers are also responsible for the balance of the development costs.

Notwithstanding having entered into the development agreements with the developers, the Company being the grantee of the land remains primarily responsible for the fulfilment of all the conditions and obligations in the Land Grant. Such conditions and obligations include the type and quantity of the developments that must be built, public facilities to be provided, and the completion date of the project.

Costs of foundation, site enabling works and land costs incurred by the Company are capitalised as property development in progress and payments received from developers are credited to property development in progress to offset costs incurred in respect of the same development. In cases where payments received from developers exceed the related expenditure incurred by the Company, such excess is recorded as deferred income (note 18B(i)). In these cases, any subsequent expenditure incurred by the Company in respect of that development will be charged against deferred income. Deferred income is to be recognised as profits of the Company at the appropriate time after charging any remaining costs related to foundation and site enabling works, and after taking into account the outstanding risks and obligations retained by the Company relating to each development. Until such time as deferred income is recognised as profit, it is recorded as a liability of the Company in recognition of the Company's obligations under the Land Grant.

The Tseung Kwan O Extension ("TKE") Project Agreement entered into in 1998 between the then Secretary for Transport, for and on behalf of the Government, and the Company in respect of the construction of the Tseung Kwan O Extension provides the Company with the right to undertake property developments at four station and depot sites along the Tseung Kwan O Line ("Tseung Kwan O Extension Property Projects") under separate land grant agreements. The basis of accounting for development costs incurred by the Company and payment related thereto is consistent with that for the property developments along the Airport Railway.

***A Property development in progress***

The Group and The Company

| *In HK$ million* | **Balance at 1 January** | **Expenditure** | **Offset against payments received from developers (note 18B(i))** | **Transfer out on project completion** | **Transfer to assets under construction** | **Balance at 31 December/ 30 June** |
|---|---|---|---|---|---|---|
| **31 December 2006** | | | | | | |
| Airport Railway Property Projects | — | 106 | (106) | — | — | — |
| Tseung Kwan O Extension Projects | 2,756 | 1,007 | (452) | (14) | — | 3,297 |
| | 2,756 | 1,113 | (558) | (14) | — | 3,297 |
| **31 December 2005** | | | | | | |
| Airport Railway Property Projects | — | 210 | (152) | (58) | — | — |
| Tseung Kwan O Extension Projects | 2,043 | 1,241 | (528) | — | — | 2,756 |
| Other property projects | 45 | 4 | (27) | (22) | — | — |
| | 2,088 | 1,455 | (707) | (80) | — | 2,756 |
| **31 December 2004** | | | | | | |
| Airport Railway Property Projects | — | 116 | (39) | — | (77) | — |
| Tseung Kwan O Extension Projects | 2,266 | 66 | (2) | (287) | — | 2,043 |
| Other property projects | 43 | 2 | — | — | — | 45 |
| | 2,309 | 184 | (41) | (287) | (77) | 2,088 |
| **30 June 2007 (unaudited)** | | | | | | |
| Airport Railway Property Projects | — | 22 | (22) | — | — | — |
| Tseung Kwan O Extension Projects | 3,297 | 103 | (200) | — | — | 3,200 |
| | 3,297 | 125 | (222) | — | — | 3,200 |
| **30 June 2006 (unaudited)** | | | | | | |
| Airport Railway Property Projects | — | 47 | (47) | — | — | — |
| Tseung Kwan O Extension Projects | 2,756 | 894 | (448) | (13) | — | 3,189 |
| | 2,756 | 941 | (495) | (13) | — | 3,189 |

Included in the amount for Tseung Kwan O Extension Projects is HK$768 million (2006: HK$768 million; 2005: nil; 2004: nil) in connection with the Company's interest-free loan of HK$4,000 million extended to the developer of Package 2, Tseung Kwan O Area 86 property development project in 2006 (note 30).

*B* ***Deferred income on property development***

The Group and The Company

| *in HK$ million* | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 (unaudited) | At 30 June 2006 (unaudited) |
|---|---|---|---|---|---|
| Deferred income on property development comprises: | | | | | |
| — Up-front payments received from developers (note 18B(i)) | 1,120 | 2,461 | 3,414 | 708 | 1,755 |
| — Sharing in kind (note 18B(ii)) | 442 | 997 | 1,092 | 400 | 702 |
| | 1,562 | 3,458 | 4,506 | 1,108 | 2,457 |

i *Deferred income on up-front payments*

The Group and The Company

| *in HK$ million* | **Balance at 1 January** | **Payments received from developers** | **Offset against property development in progress (note 18A)** | **Amount recognised as profit (note 7)** | **Balance at 31 December/ 30 June** |
|---|---|---|---|---|---|
| **31 December 2006** | | | | | |
| Airport Railway Property Projects | 2,419 | 20 | (106) | (1,213) | 1,120 |
| Tseung Kwan O Extension Property Projects | 42 | 410 | (452) | — | — |
| | 2,461 | 430 | (558) | (1,213) | 1,120 |
| **31 December 2005** | | | | | |
| Airport Railway Property Projects | 3,409 | 956 | (152) | (1,794) | 2,419 |
| Tseung Kwan O Extension Property Projects | 5 | 565 | (528) | — | 42 |
| Other property projects | — | 27 | (27) | — | — |
| | 3,414 | 1,548 | (707) | (1,794) | 2,461 |
| **31 December 2004** | | | | | |
| Airport Railway Property Projects | 4,917 | 132 | (39) | (1,601) | 3,409 |
| Tseung Kwan O Extension Property Projects | 7 | — | (2) | — | 5 |
| | 4,924 | 132 | (41) | (1,601) | 3,414 |
| **30 June 2007 (unaudited)** | | | | | |
| Airport Railway Property Projects | 1,120 | 120 | (22) | (510) | 708 |
| Tseung Kwan O Extension Property Projects | — | 200 | (200) | — | — |
| | 1,120 | 320 | (222) | (510) | 708 |
| **30 June 2006 (unaudited)** | | | | | |
| Airport Railway Property Projects | 2,419 | — | (47) | (621) | 1,751 |
| Tseung Kwan O Extension Property Projects | 42 | 410 | (448) | — | 4 |
| | 2,461 | 410 | (495) | (621) | 1,755 |

ii *Deferred income on sharing in kind*

Under the property development agreement in respect of an Airport Railway development package, the Company received during 2004 certain portions of the shell of a retail centre at Union Square, Kowloon Station and its car parking spaces. Part of the property development profit is deferred as the Company has an obligation under the development agreement to complete the fitting-out works. On this basis, movements of the deferred income on this sharing in kind are set out below:

The Group and The Company

| | **At 31 December** | | | **At 30 June** | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Balance as at 1 January | 997 | 1,092 | — | 442 | 997 |
| Sharing in kind received from developer | — | — | 2,100 | — | — |
| Less: Amount recognised as profit (note 7) | (555) | (95) | (1,008) | (42) | (295) |
| Balance as at 31 December/30 June | 442 | 997 | 1,092 | 400 | 702 |

**C** ***Stakeholding funds***

As stakeholder under certain Airport Railway and Tseung Kwan O Extension Property Projects, the Company receives and manages deposit monies and sales proceeds in respect of sales of properties under those developments. These monies are placed in separate designated bank accounts and, together with any interest earned, will be released to the developers for the reimbursement of costs of the respective developments in accordance with the terms and conditions of the Government Consent Schemes and development agreements. Any balance remaining will only be released for distribution after all obligations relating to the developments have been met. Accordingly, the balances of the stakeholding funds and the corresponding bank balances have not been included in the Group's and the Company's balance sheets. Movements in stakeholding funds were as follows:

The Group and The Company

| | **At 31 December** | | | **At 30 June** | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Balance as at 1 January | 3,478 | 4,064 | 3,572 | 6,860 | 3,478 |
| Stakeholding funds received and receivable | 22,843 | 15,599 | 13,958 | 9,917 | 4,371 |
| Add: Interest earned thereon | 176 | 111 | 8 | 135 | 57 |
| | 26,497 | 19,774 | 17,538 | 16,912 | 7,906 |
| Disbursements during the year/period | (19,637) | (16,296) | (13,474) | (11,436) | (4,383) |
| Balance as at 31 December/30 June | 6,860 | 3,478 | 4,064 | 5,476 | 3,523 |
| Represented by : | | | | | |
| Balances in designated bank accounts as at 31 December/30 June | 6,858 | 3,476 | 4,062 | 5,474 | 3,521 |
| Retention receivable | 2 | 2 | 2 | 2 | 2 |
| | 6,860 | 3,478 | 4,064 | 5,476 | 3,523 |

## 19 Deferred expenditure

| *in HK$ million* | Balance at 1 January, as previously reported | Effect of adoption of new accounting policy with respect to financial instruments | Balance at 1 January | Transfer to railway construction in progress (note 17) | Discount on bond issue | Expenditure/ (Amortisation) during the year/period | Costs written off to profit and loss account | Balance at 31 December/ 30 June |
|---|---|---|---|---|---|---|---|---|
| The Group | | | | | | | | |
| **31 December 2006** | | | | | | | | |
| Merger studies | 72 | — | 72 | — | — | 98 | — | 170 |
| Expenditure on proposed capital projects | 209 | — | 209 | — | — | 186 | — | 395 |
| | 281 | — | 281 | — | — | 284 | — | 565 |
| **31 December 2005** | | | | | | | | |
| Deferred finance charges | 109 | (109) | — | — | — | — | — | — |
| Merger studies | 56 | — | 56 | — | — | 16 | — | 72 |
| Expenditure on proposed capital projects | 78 | — | 78 | — | — | 131 | — | 209 |
| | 243 | (109) | 134 | — | — | 147 | — | 281 |
| **31 December 2004** | | | | | | | | |
| Deferred finance charges | 76 | — | 76 | — | 50 | (17) | — | 109 |
| Merger studies | — | — | — | — | — | 56 | — | 56 |
| Expenditure on proposed capital projects | 28 | — | 28 | (3) | — | 68 | (15) | 78 |
| | 104 | — | 104 | (3) | 50 | 107 | (15) | 243 |
| **30 June 2007 (unaudited)** | | | | | | | | |
| Merger studies | 170 | — | 170 | — | — | 42 | — | 212 |
| Expenditure on proposed capital projects | 395 | — | 395 | — | — | 136 | — | 531 |
| | 565 | — | 565 | — | — | 178 | — | 743 |
| **30 June 2006 (unaudited)** | | | | | | | | |
| Merger studies | 72 | — | 72 | — | — | 23 | — | 95 |
| Expenditure on proposed capital projects | 209 | — | 209 | — | — | 116 | — | 325 |
| | 281 | — | 281 | — | — | 139 | — | 420 |
| The Company | | | | | | | | |
| **31 December 2006** | | | | | | | | |
| Merger studies | 72 | — | 72 | — | — | 98 | — | 170 |
| Expenditure on proposed capital projects | 43 | — | 43 | — | — | 70 | — | 113 |
| | 115 | — | 115 | — | — | 168 | — | 283 |
| **31 December 2005** | | | | | | | | |
| Deferred finance charges | 109 | (109) | — | — | — | — | — | — |
| Merger studies | 56 | — | 56 | — | — | 16 | — | 72 |
| Expenditure on proposed capital projects | 27 | — | 27 | — | — | 16 | — | 43 |
| | 192 | (109) | 83 | — | — | 32 | — | 115 |
| **31 December 2004** | | | | | | | | |
| Deferred finance charges | 76 | — | 76 | — | 50 | (17) | — | 109 |
| Merger studies | — | — | — | — | — | 56 | — | 56 |
| Expenditure on proposed capital projects | 28 | — | 28 | (3) | — | 17 | (15) | 27 |
| | 104 | — | 104 | (3) | 50 | 56 | (15) | 192 |
| **30 June 2007 (unaudited)** | | | | | | | | |
| Merger studies | 170 | — | 170 | — | — | 42 | — | 212 |
| Expenditure on proposed capital projects | 113 | — | 113 | — | — | 18 | — | 131 |
| | 283 | — | 283 | — | — | 60 | — | 343 |

| *in HK$ million* | Balance at 1 January, as previously reported | Effect of adoption of new accounting policy with respect to financial instruments | Balance at 1 January | Transfer to railway construction in progress (note 17) | Discount on bond issue | Expenditure/ (Amortisation) during the year/period | Costs written off to profit and loss account | Balance at 31 December/ 30 June |
|---|---|---|---|---|---|---|---|---|
| The Company | | | | | | | | |
| **30 June 2006 (unaudited)** | | | | | | | | |
| Merger studies | 72 | — | 72 | — | — | 23 | — | 95 |
| Expenditure on proposed capital projects | 43 | — | 43 | — | — | 44 | — | 87 |
| | 115 | — | 115 | — | — | 67 | — | 182 |

Merger studies comprise external consultancy, incremental direct staff costs and expenses in relation to the studies on the proposed merger between the Company and Kowloon-Canton Railway Corporation.

As at 30 June 2007, the balance of expenditure incurred on proposed capital projects mainly relates to design works for the Shenzhen Metro Line 4 Project in China and the West Island Line Project in Hong Kong.

## 20 Prepaid land lease payments

The Group and The Company

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Cost | | | | | |
| At 1 January | 732 | 732 | 732 | 732 | 732 |
| Addition | — | — | — | — | — |
| At 31 December/30 June | 732 | 732 | 732 | 732 | 732 |
| Accumulated amortisation | | | | | |
| At 1 January | 124 | 111 | 98 | 138 | 124 |
| Charge for the year/period | 14 | 13 | 13 | 7 | 7 |
| At 31 December/30 June | 138 | 124 | 111 | 145 | 131 |
| Net book value at 31 December/30 June | 594 | 608 | 621 | 587 | 601 |

*A* The above prepaid land lease payments, all of which relate to land held for railway depots in Hong Kong, is analysed as follows:

The Group and The Company

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| At net book value | | | | | |
| — long leases | 157 | 160 | 163 | 155 | 159 |
| — medium-term leases | 437 | 448 | 458 | 432 | 442 |
| | 594 | 608 | 621 | 587 | 601 |

*B* The lease of the land on which the civil works, plant and equipment are situated for the operation of the railway was granted to the Company under a running line lease for the period up to 29 June 2050 which can be extended for further periods of 50 years at nominal payment (note 45C).

Under the terms of the lease, the Company undertakes to keep and maintain all the leased areas, including underground and overhead structures, at its own cost. With respect to parts of the railway situated in structures where access is shared with other users, such as the Lantau Fixed Crossing, the Company's obligation for maintenance is limited to the railway only. All maintenance costs incurred under the terms of the lease have been dealt with as railway operating costs in the profit and loss account.

**21 Interests in non-controlled subsidiaries**

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| The Group | | | | | |
| Share of net assets | 171 | 103 | 63 | 213 | 131 |
| | 171 | 103 | 63 | 213 | 131 |
| The Company | | | | | |
| Unlisted shares, at cost | 24 | 24 | 24 | 24 | 24 |
| | 24 | 24 | 24 | 24 | 24 |

The following list contains the particulars of all major non-controlled subsidiaries of the Group as at 30 June 2007:

| Name of company | Issued and paid up ordinary share capital | Proportion of ownership interest: Group's effective interest | Held by the Company | Held by subsidiary | Place of incorporation and operation | Principal activities |
|---|---|---|---|---|---|---|
| Octopus Holdings Limited | HK$42,000,000 | 57.4% | 57.4% | — | Hong Kong | Investment holding |
| Octopus Cards Limited | HK$42,000,000 | 57.4% | — | 100% | Hong Kong | Operate a contactless smartcard common payment system in Hong Kong |
| Octopus Connect Limited | HK$2 | 57.4% | — | 100% | Hong Kong | Customer relationship management service |
| Octopus Investments Limited | HK$2 | 57.4% | — | 100% | Hong Kong | Investment holding |
| Octopus Knowledge Limited | HK$2 | 57.4% | — | 100% | Hong Kong | Marketing and management of overseas automatic fare collection consultancy projects |
| Octopus Netherlands Limited | HK$1 | 57.4% | — | 100% | Hong Kong | Consultancy services on introducing a smartcard system in the Netherlands |
| Octopus Rewards Limited | HK$1 | 57.4% | — | 100% | Hong Kong | Develop and operate a common loyalty scheme |
| Octopus Cards Macau Limited | MOP10,000 | 57.4% | — | 100% | Macau | Promote the contactless smartcard common payment system in Macau |
| Octopus Cards (NL) B.V. | EUR18,000 | 57.4% | — | 100% | Netherlands | Project management on introducing a smartcard system in the Netherlands |

In June 1994, the Company entered into an agreement with four local transport companies, Kowloon-Canton Railway Corporation, The Kowloon Motor Bus Company (1933) Limited (subsequently replaced by KMB Public Bus Services Holdings Limited), Citybus Limited and The Hongkong and Yaumati Ferry Co., Limited (subsequently replaced by New World First Bus Services Limited and New World First Ferry Services Limited), to incorporate a company, Creative Star Limited, now Octopus Cards Limited ("OCL"), to undertake the development and operation of the "Octopus" contactless smart card ticketing system, which was initially used by the shareholding transport companies. Although the Company currently holds a 57.4% interest in the issued shares of OCL, its appointees to the Board of Directors of OCL are limited to 49% of the voting rights at board meetings. The shareholders have agreed to provide the necessary funding to OCL for its operations and for the development of the "Octopus" system.

On 20 April 2000, OCL received approval from The Hong Kong Monetary Authority ("HKMA") to become a deposit-taking company ("DTC") for purposes of extending the use of Octopus cards to a wider range of services, including those that are non-transport related. Prior to becoming a DTC, the Octopus card was exempted from the definition of "multi-purpose card" under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) on the basis that its use was restricted to transport related services only.

On 17 January 2001, the Company entered into a new Shareholders' Agreement with the other shareholders of OCL. Under this agreement, the Company disposed of a shareholding interest of 10.4% in OCL to certain other shareholders of OCL for a consideration of HK$16 million, together with a deferred consideration to be received in the event of OCL subsequently becoming a stock exchange listed company.

On 21 October 2005, the Company and the other shareholders of OCL entered into a number of agreements to adjust the arrangements relating to OCL, in order to make the non-payment businesses of OCL into new, separate subsidiaries independent of the payment business of OCL that is regulated by the HKMA. Accordingly, a new holding company, Octopus Holdings Limited ("OHL"), has been set up to hold the entire issued share capital of each of these new companies as well as OCL. The Company's effective interest in OHL and its subsidiaries is 57.4%.

At the same time, the shareholders of OHL made a loan in aggregate amounting to HK$150 million to OHL pursuant to a Subordinated Loan Agreement, with each shareholder lending an amount in proportion to its shareholding in OHL. The Company has therefore lent HK$86 million to OHL (or 57.4% of the total amount of the loan). The loan is for a term of five years and is unsecured, the rights of the lenders are subordinated in all respects to the rights of the other unsubordinated creditors of OHL in respect of all other unsubordinated liabilities, and interest on the loan is payable at a rate of 5.5% per annum.

During the six months ended 30 June 2007, a total amount of HK$29 million (2006: HK$56 million; 2005: HK$54 million; 2004: HK$51 million) was paid by the Company to OCL in respect of the central clearing services provided by OCL to the Company. During the same period, load agent fees and fees for handling Octopus card issuance and refund amounting to HK$5 million (2006: HK$9 million; 2005: HK$9 million; 2004: HK$10 million) and HK$2 million (2006: HK$5 million; 2005: HK$5 million; 2004: HK$6 million) respectively were received from OCL in respect of services and facilities provided by the Company at various MTR stations.

During the six months ended 30 June 2007, services fees amounting to HK$1 million (2006: HK$2 million; 2005: HK$2 million; 2004: HK$2 million) were also received from OCL in respect of rental of computer equipment and services and warehouse storage space payable to the Company under a service agreement.

The condensed consolidated profit and loss account and the balance sheet for OHL are shown below:

**Consolidated profit and loss account**

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** *(audited)* | **2005** *(audited)* | **2004** *(audited)* | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Turnover | 382 | 332 | 262 | 207 | 176 |
| Other operating income | 23 | 22 | 55 | 16 | 19 |
| | 405 | 354 | 317 | 223 | 195 |
| Staff costs | (99) | (78) | (66) | (49) | (46) |
| Load agent fees and bank charges for add value services | (54) | (47) | (41) | (29) | (26) |
| Other expenses | (97) | (100) | (80) | (57) | (51) |
| Operating profit before depreciation | 155 | 129 | 130 | 88 | 72 |
| Depreciation | (70) | (89) | (81) | (35) | (35) |
| Operating profit before interest and finance charges | 85 | 40 | 49 | 53 | 37 |
| Net interest income | 55 | 41 | 28 | 35 | 24 |
| Profit before taxation | 140 | 81 | 77 | 88 | 61 |
| Income tax | (22) | (12) | (8) | (14) | (13) |
| Profit for the year/period | 118 | 69 | 69 | 74 | 48 |
| **Group's share of profit before taxation** (note 10) | 80 | 47 | 44 | 50 | 36 |
| **Group's share of income tax** (note 10) | (12) | (7) | (5) | (8) | (8) |
| Dividend | — | — | 150 | — | — |
| **Group's share of dividend** | — | — | 86 | — | — |

**Consolidated balance sheet**

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** *(audited)* | **2005** *(audited)* | **2004** *(audited)* | **2007** *(unaudited)* | **2006** *(unaudited)* |
| **Assets** | | | | | |
| Fixed assets | 156 | 158 | 201 | 137 | 161 |
| Investments | 1,521 | 1,210 | 993 | 1,732 | 1,301 |
| Cash at banks and on hand | 314 | 336 | 259 | 252 | 346 |
| Other assets | 190 | 129 | 101 | 170 | 106 |
| | 2,181 | 1,833 | 1,554 | 2,291 | 1,914 |
| **Liabilities** | | | | | |
| Card floats and card deposits due to cardholders | (1,446) | (1,311) | (1,208) | (1,054) | (1,357) |
| Amounts due to shareholders | (65) | (41) | (167) | (42) | (21) |
| Other liabilities | (373) | (301) | (68) | (823) | (308) |
| | (1,884) | (1,653) | (1,443) | (1,919) | (1,686) |
| **Net assets** | 297 | 180 | 111 | 372 | 228 |
| **Equity** | | | | | |
| Share capital | 42 | 42 | 42 | 42 | 42 |
| Retained profits | 255 | 138 | 69 | 330 | 186 |
| | 297 | 180 | 111 | 372 | 228 |
| **Group's share of net assets** | 171 | 103 | 63 | 213 | 131 |

**22 Investments in subsidiaries**

The Company

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Unlisted shares, at cost | 187 | 185 | 185 | 187 | 185 |
| Less: Impairment losses | 3 | 3 | 3 | 3 | 3 |
| | 184 | 182 | 182 | 184 | 182 |

Investments in subsidiaries include HK$24 million (2006: HK$24 million; 2005: HK$24 million; 2004: HK$24 million) in respect of investments in non-controlled subsidiaries. Details of which are disclosed in note 21. The following list contains details of controlled subsidiaries as defined under note 2C as at 30 June 2007, which have been consolidated into the Group's financial statements.

| Name of company | Issued and paid up ordinary/ registered share capital | Proportion of ownership interest: Group's effective interest | Held by the Company | Held by subsidiary | Place of incorporation and operation | Principal activities |
|---|---|---|---|---|---|---|
| Glory Goal Limited | HK$10,000 | 100% | 100% | — | Hong Kong | Investment holding |
| MTR (Shanghai Project Management) Limited | HK$1,000 | 100% | 100% | — | Hong Kong | Railway consultancy services, property investment and development |
| MTR Beijing Line 4 Investment Company Limited | HK$1 | 100% | 100% | — | Hong Kong | Investment holding |
| MTR China Consultancy Company Limited | HK$1,000 | 100% | 100% | — | Hong Kong | Railway consultancy services |
| MTR China Property Limited | HK$1,000 | 100% | 100% | — | Hong Kong | Property management |
| MTR Engineering Services Limited | HK$1,000 | 100% | 100% | — | Hong Kong | Engineering services |
| MTR Property Agency Co. Limited | HK$2 | 100% | 100% | — | Hong Kong | Property agency |
| MTR Rail Transport Training (International) Company Limited | HK$2,800,000 | 100% | 100% | — | Hong Kong | Provide rail transport training |
| MTR Shenzhen Investment Holding Limited | HK$400,000 | 100% | 100% | — | Hong Kong | Investment holding |
| MTR Telecommunication Company Limited | HK$100,000,000 | 100% | 100% | — | Hong Kong | Radio communication services |
| MTR Travel Limited | HK$2,500,000 | 100% | 100% | — | Hong Kong | Travel services |
| Rail Sourcing Solutions (International) Limited | HK$2 | 100% | 100% | — | Hong Kong | Global railway supply and sourcing services |
| TraxComm Limited | HK$15,000,000 | 100% | 100% | — | Hong Kong | Fixed telecommunication network services |
| Hong Kong Cable Car Limited* | HK$1,000 | 100% | 100% | — | Hong Kong | Dormant |
| Lantau Cable Car Limited* | HK$1,000 | 100% | 100% | — | Hong Kong | Dormant |
| MTR (Estates Management) Limited* | HK$1,000 | 100% | 100% | — | Hong Kong | Dormant |
| MTR (Shanghai Metro Management) Limited* | HK$1,000 | 100% | 100% | — | Hong Kong | Dormant |
| Candiman Limited* | US$1 | 100% | 100% | — | British Virgin Islands | Investment holding |
| Fasttrack Insurance Ltd. | HK$77,500,000 | 100% | 100% | — | Bermuda | Insurance underwriting |

| Name of company | Issued and paid up ordinary/ registered share capital | Proportion of ownership interest: Group's effective interest | Held by the Company | Held by subsidiary | Place of incorporation and operation | Principal activities |
|---|---|---|---|---|---|---|
| MTR Corporation (C.I.) Limited | US$1,000 | 100% | 100% | — | Cayman Islands/Hong Kong | Finance |
| MTR Finance Lease (001) Limited* | US$1 | 100% | 100% | — | Cayman Islands/Hong Kong | Finance |
| Chongqing Premier Property Management Co. Ltd.* (Incorporated) | US$150,000 | 70% | — | 70% | The People's Republic of China | Property management |
| MTR (Beijing) Commercial Facilities Management Co. Ltd. (Incorporated) | HK$93,000,000 | 100% | — | 100% | The People's Republic of China | Property management |
| MTR (Beijing) Property Services Co. Limited* (Incorporated) | RMB3,000,000 | 100% | 100% | — | The People's Republic of China | Property management |
| MTR Consultancy (Beijing) Co. Ltd. (Incorporated) | HK$1,000,000 | 100% | 100% | — | The People's Republic of China | Railway consultancy services, marketing and promotion |
| MTR Consulting (Shenzhen) Co. Ltd. (Incorporated) | HK$1,000,000 | 100% | 100% | — | The People's Republic of China | Railway consultancy services |
| MTR Corporation (Shenzhen) Limited (Incorporated) | HK$250,000,000 | 100% | — | 100% | The People's Republic of China | Conduct early-stage preparatory work for Shenzhen Metro Line 4 project |
| Shanghai Hong Kong Metro Construction Management Co. Ltd. (Incorporated) | HK$15,000,000 | 60% | — | 60% | The People's Republic of China | Railway construction management and development |
| MTR Corporation (IKF) Limited | GBP29 | 100% | — | 100% | United Kingdom | Investment holding |
| MTR Corporation (No.2) Limited | GBP1 | 100% | — | 100% | United Kingdom | Investment holding |
| MTR Corporation (Silverlink) Limited* | GBP1 | 100% | — | 100% | United Kingdom | Investment holding |
| MTR Corporation (SWT) Limited* | GBP1 | 100% | — | 100% | United Kingdom | Investment holding |
| MTR Corporation (UK) Limited | GBP29 | 100% | 100% | — | United Kingdom | Investment holding |
| Rail Sourcing Solutions (UK) Limited * | GBP1 | 100% | — | 100% | United Kingdom | Railway supply and sourcing services |

* Subsidiaries not audited by KPMG. The financial statements of the subsidiaries not audited by KPMG reflect total net assets and total turnover constituting less than 1% of the respective consolidated totals.

## 23 Interests in associates

The Group

| *in HK$ million* | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 *(unaudited)* | At 30 June 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Share of net assets | 100 | — | — | 203 | 100 |

The Group and the Company had interests in the following associates as at 30 June 2007:

| Name of company | Issued and paid up ordinary/ registered share capital | Proportion of ownership interest: Group's effective interest | Proportion of ownership interest: Held by the Company | Proportion of ownership interest: Held by subsidiary | Place of incorporation and operation | Principal activities |
|---|---|---|---|---|---|---|
| Beijing MTR Corporation Limited (Incorporated) | RMB1,380,000,000 | 49% | — | 49% | The People's Republic of China | Railway construction, management and development |
| London Overground Railway Operations Limited (previously known as MTR Laing Metro Limited)* | GBP2 | 50% | — | 50% | United Kingdom | Bidding vehicle |
| MTR Laing Railway Company Limited* | GBP2 | 50% | — | 50% | United Kingdom | Bidding vehicle |
| South Western Railway Limited* | GBP2 | 50% | — | 50% | United Kingdom | Bidding vehicle |

* Companies not audited by KPMG.

MTR Laing Railway Company Limited, a joint venture company established for bidding the Thameslink/Great Northern Franchise in United Kingdom in which the Group held 50% interest, had been dissolved on 10 July 2007 following unsuccessful bidding of the franchise.

The registered share capital of Beijing MTR Corporation Limited is RMB1,380 million of which 49% (RMB676 million) is to be contributed by the Group. During the six months ended 30 June 2007, the Group has made a further equity contribution of HK$103 million making accumulated equity contribution of HK$203 million as at 30 June 2007.

The summary financial information of the Group's effective interests in associates is as follows:

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Non-current assets | 185 | — | — | 354 | 14 |
| Current assets | 6 | 2 | — | 8 | 88 |
| Non-current liabilities | (25) | — | — | (178) | (11) |
| Current liabilities | (105) | (33) | — | — | (18) |
| Net assets/(liabilities) | 61 | (31) | — | 184 | 73 |
| Income | — | — | — | — | — |
| Expenses | (23) | (31) | — | — | (12) |
| Loss for the year/period | (23) | (31) | — | — | (12) |

The above financial information included the results of Beijing MTR Corporation Limited, whose condensed profit and loss account and the balance sheet are shown below:

| **Profit and loss account** *in HK$ million* | **For the period from 16 January 2006 (date of incorporation) to 31 December 2006** *(unaudited)* | **Six months ended 30 June 2007** *(unaudited)* | **For the period from 16 January 2006 (date of incorporation) to 30 June 2006** *(unaudited)* |
|---|---|---|---|
| Net loss for the period | — | — | — |
| **Group's share of loss for the period** | — | — | — |

| **Balance sheet** *in HK$ million* | **At 31 December 2006** *(unaudited)* | **At 30 June 2007** *(unaudited)* | **At 30 June 2006** *(unaudited)* |
|---|---|---|---|
| **Assets** | | | |
| Fixed assets | 6 | 8 | 5 |
| Construction in progress | 372 | 715 | 23 |
| Other assets | 10 | 16 | 176 |
| | 388 | 739 | 204 |
| **Liabilities** | | | |
| Creditors, accrued charges and provisions | (48) | (54) | — |
| Loans | (135) | (258) | — |
| | (183) | (312) | — |
| **Net assets** | 205 | 427 | 204 |
| **Equity** | | | |
| Share capital | 202 | 412 | 202 |
| Exchange reserve | 3 | 15 | 2 |
| | 205 | 427 | 204 |
| **Group's share of net assets (before exchange reserve)** | 100 | 203 | 100 |

## 24 Investments in securities

Investments in securities represent debt securities held by an overseas insurance underwriting subsidiary comprising:

The Group

| | **At 31 December** | | | **At 30 June** | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Trading securities listed overseas, at fair value (2004: at cost) | | | | | |
| — maturing within 1 year | 35 | 23 | 68 | 46 | 33 |
| — maturing after 1 year | 237 | 160 | 134 | 294 | 172 |
| | 272 | 183 | 202 | 340 | 205 |

These securities were originally acquired with an intention to hold to maturity and were classified as held to maturity securities stated at cost in 2004. In 2005, management changed its intention to allow trading of securities held to enable more effective portfolio management. The investments were reclassified as trading securities and were stated at their fair value as at 31 December 2006 and 2005, and 30 June 2007 and 2006. No prior period adjustment on the 2004 comparative figure has been made as the adjustment, which amounting to HK$1 million, was considered insignificant.

**25 Staff housing loans**

The Group and The Company

| *in HK$ million* | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 (unaudited) | At 30 June 2006 (unaudited) |
|---|---|---|---|---|---|
| Balance at 1 January | 34 | 47 | 67 | 25 | 34 |
| Redemption | (5) | (8) | (13) | (5) | (2) |
| Repayment | (4) | (5) | (7) | (2) | (3) |
| Balance at 31 December/30 June | 25 | 34 | 47 | 18 | 29 |

The Group and The Company

| *in HK$ million* | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 (unaudited) | At 30 June 2006 (unaudited) |
|---|---|---|---|---|---|
| Amounts receivable: | | | | | |
| — within 1 year | 4 | 5 | 5 | 3 | 4 |
| — after 1 year | 21 | 29 | 42 | 15 | 25 |
| | 25 | 34 | 47 | 18 | 29 |

The MTR Staff Housing Loan Scheme, a Company financed scheme, was introduced in 1997 to replace, on a phased basis, the previous arrangements whereby interest subsidies were paid by the Company to eligible employees. All housing loans granted to employees carry interest either at the prevailing Best Lending Rate less 1.75% per annum or at the Company's Average Cost of Borrowings plus 0.75% per annum, and are secured by mortgages over the relevant properties.

The Company considers that the nominal value of housing loans are not significantly different from their fair values.

**26 Properties held for sale**

The Group and The Company

| *in HK$ million* | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 (unaudited) | At 30 June 2006 (unaudited) |
|---|---|---|---|---|---|
| Properties held for sale | | | | | |
| — at cost | 876 | 1,090 | 597 | 1,504 | 2,349 |
| — at net realisable value | 1,142 | 221 | 218 | 660 | 1,015 |
| | 2,018 | 1,311 | 815 | 2,164 | 3,364 |

Properties held for sale at 30 June 2007 comprised mainly residential units, retail and car parking spaces at the Olympic Station, Kowloon Station and Tung Chung Station along the Airport Railway, as well as Tiu Keng Leng Station, Tseung Kwan O Area 55b and Area 57a developments along the Tseung Kwan O Line. They represent either properties received by the Company as sharing in kind or as part of the profit distribution upon completion of the development and the attributable interest in unsold units of shared surplus developments for which occupation permits have been issued. The properties are stated in the balance sheet at the lower of cost, which is deemed to be their fair value upon initial recognition as determined by reference to an independent open market valuation at the date of receipt (notes 2J(vi) and (viii)), and their net realisable value at the balance sheet date. Net realisable value represents the estimated selling price less costs to be incurred in selling the properties. The net realisable values as at 30 June 2006 and 2007, and 31 December 2004, 2005 and 2006 are determined by reference to an open market valuation of the properties as at those dates, undertaken by an independent firm of surveyors, DTZ Debenham Tie Leung, who have among their staff Members of the Hong Kong Institute of Surveyors.

Properties held for sale at net realisable value at 30 June 2007 are stated net of provision of HK$51 million (2006: HK$49 million; 2005: HK$18 million; 2004: HK$18 million), made in order to state these properties at the lower of their cost and estimated net realisable value.

## 27 Derivative financial assets and liabilities

### *A Fair value*

The contracted notional amounts, fair values and maturities of derivative instruments outstanding on 31 December 2006 and 2005, and 30 June 2007 and 2006 are as follows:

The Group and The Company

| | **Notional amount** | | | **Fair values Maturing in** | | |
|---|---|---|---|---|---|---|
| *in HK$ million* | | **Less than 1 year** | **1-2 years** | **2-5 years** | **Over 5 years** | **Total** |
| **At 31 December 2006** | | | | | | |
| **Derivative financial assets** | | | | | | |
| Foreign exchange forwards | | | | | | |
| — cash flow hedges | 418 | 1 | 4 | — | — | 5 |
| — not qualified as hedges | 650 | 4 | — | — | — | 4 |
| Cross currency swaps | | | | | | |
| — fair value hedges | 2,032 | 4 | 4 | 45 | — | 53 |
| Interest rate swaps | | | | | | |
| — fair value hedges | 3,373 | 2 | 11 | 44 | 71 | 128 |
| — cash flow hedges | 400 | — | 4 | — | — | 4 |
| — not qualified as hedges | 1,000 | 1 | — | — | — | 1 |
| | 7,873 | 12 | 23 | 89 | 71 | 195 |
| **Derivative financial liabilities** | | | | | | |
| Foreign exchange forwards | | | | | | |
| — cash flow hedges | 9 | 1 | — | — | — | 1 |
| — not qualified as hedges | 1 | — | — | — | — | — |
| Cross currency swaps | | | | | | |
| — fair value hedges | 14,480 | — | — | 190 | 268 | 458 |
| Interest rate swaps | | | | | | |
| — fair value hedges | 150 | — | — | 1 | 25 | 26 |
| — cash flow hedges | 2,242 | — | — | 7 | 17 | 24 |
| — not qualified as hedges | 1,908 | 6 | — | — | — | 6 |
| | 18,790 | 7 | — | 198 | 310 | 515 |
| **Total** | 26,663 | | | | | |

The Group and The Company

| *in HK$ million* | Notional amount | Fair values Maturing in Less than 1 year | 1-2 years | 2-5 years | Over 5 years | Total |
|---|---|---|---|---|---|---|
| **At 31 December 2005** | | | | | | |
| **Derivative financial assets** | | | | | | |
| Foreign exchange forwards | | | | | | |
| — cash flow hedges | 478 | 1 | — | — | — | 1 |
| Cross currency swaps | | | | | | |
| — fair value hedges | 2,517 | 1 | 1 | 68 | 6 | 76 |
| Interest rate swaps | | | | | | |
| — fair value hedges | 4,219 | 5 | — | 84 | 32 | 121 |
| — cash flow hedges | 2,000 | 14 | — | 13 | — | 27 |
| — not qualified as hedges | 900 | 8 | — | 1 | — | 9 |
| | 10,114 | 29 | 1 | 166 | 38 | 234 |
| **Derivative financial liabilities** | | | | | | |
| Foreign exchange forwards | | | | | | |
| — cash flow hedges | 25 | 1 | — | — | — | 1 |
| — not qualified as hedges | 95 | 5 | — | — | — | 5 |
| Cross currency swaps | | | | | | |
| — fair value hedges | 14,015 | — | — | 128 | 153 | 281 |
| Interest rate swaps | | | | | | |
| — fair value hedges | 750 | — | — | 3 | 12 | 15 |
| — cash flow hedges | 100 | — | 1 | — | — | 1 |
| — not qualified as hedges | 650 | — | 4 | — | — | 4 |
| | 15,635 | 6 | 5 | 131 | 165 | 307 |
| **Total** | 25,749 | | | | | |

The Group and The Company

| *in HK$ million* | Notional amount | Fair values Maturing in Less than 1 year | 1-2 years | 2-5 years | Over 5 years | Total |
|---|---|---|---|---|---|---|
| **At 30 June 2007 (unaudited)** | | | | | | |
| **Derivative financial assets** | | | | | | |
| Foreign exchange forwards | | | | | | |
| — fair value hedges | 7 | — | — | — | — | — |
| — cash flow hedges | 895 | 12 | 7 | — | — | 19 |
| — not qualified as hedges | 445 | 5 | 1 | — | — | 6 |
| Cross currency swaps | | | | | | |
| — fair value hedges | 3,849 | 4 | 38 | 8 | 6 | 56 |
| Interest rate swaps | | | | | | |
| — fair value hedges | 2,281 | 4 | 4 | 24 | 14 | 46 |
| — cash flow hedges | 2,542 | — | 7 | 14 | 43 | 64 |
| — not qualified as hedges | 100 | — | 1 | — | — | 1 |
| | 10,119 | 25 | 58 | 46 | 63 | 192 |
| **Derivative financial liabilities** | | | | | | |
| Foreign exchange forwards | | | | | | |
| — cash flow hedges | 13 | 1 | — | — | — | 1 |
| Cross currency swaps | | | | | | |
| — fair value hedges | 12,653 | — | 11 | 44 | 130 | 185 |
| Interest rate swaps | | | | | | |
| — fair value hedges | 2,423 | — | — | 4 | 90 | 94 |
| — not qualified as hedges | 1,000 | 1 | — | — | — | 1 |
| | 16,089 | 2 | 11 | 48 | 220 | 281 |
| **Total** | 26,208 | | | | | |

The Group and The Company

| *in HK$ million* | **Notional amount** | **Fair values Maturing in** Less than 1 year | 1-2 years | 2-5 years | Over 5 years | Total |
|---|---|---|---|---|---|---|
| **At 30 June 2006 (unaudited)** | | | | | | |
| **Derivative financial assets** | | | | | | |
| Foreign exchange forwards | | | | | | |
| — cash flow hedges | 334 | — | — | — | — | — |
| — not qualified as hedges | 96 | 2 | — | 1 | — | 3 |
| Cross currency swaps | | | | | | |
| — fair value hedges | 2,507 | — | — | 34 | 4 | 38 |
| Interest rate swaps | | | | | | |
| — fair value hedges | 2,722 | — | 7 | 25 | 9 | 41 |
| — cash flow hedges | 1,800 | 6 | — | 17 | — | 23 |
| — not qualified as hedges | 2,158 | 6 | — | 2 | — | 8 |
| | 9,617 | 14 | 7 | 79 | 13 | 113 |
| **Derivative financial liabilities** | | | | | | |
| Foreign exchange forwards | | | | | | |
| — cash flow hedges | 13 | 1 | 1 | — | — | 2 |
| — not qualified as hedges | 4 | — | — | — | — | — |
| Cross currency swaps | | | | | | |
| — fair value hedges | 14,015 | — | — | 134 | 184 | 318 |
| Interest rate swaps | | | | | | |
| — fair value hedges | 1,250 | — | — | 6 | 117 | 123 |
| — not qualified as hedges | 450 | — | — | — | — | — |
| | 15,732 | 1 | 1 | 140 | 301 | 443 |
| **Total** | 25,349 | | | | | |

No fair values and maturities of derivative instruments outstanding on 31 December 2004 were analysed as the new requirements were adopted prospectively from 1 January 2005. The notional amounts and maturities of derivative instruments outstanding on 31 December 2004 are as follows:

The Group and The Company

| *in HK$ million* | **Total** | **Notional amount Maturing in** Less than 1 year | 1-2 years | 2-5 years | Over 5 years |
|---|---|---|---|---|---|
| **At 31 December 2004** | | | | | |
| Foreign exchange forwards | 432 | 351 | 51 | 30 | — |
| Cross currency swaps | 19,267 | 2,734 | 20 | 5,896 | 10,617 |
| Interest rate swaps | 14,723 | 6,100 | 3,850 | 2,527 | 2,246 |
| | 34,422 | 9,185 | 3,921 | 8,453 | 12,863 |

The discounted cash flow method, which discounts the future contractual cash flows at the current market interest and foreign exchange rates that are available to the Group for similar financial instruments, is the main valuation technique used to determine the fair value of the Group's borrowings and derivative financial instruments such as interest rate swaps and cross currency swaps. The fair value of forward foreign exchange contracts is determined using forward exchange market rates at the balance sheet date.

The Group's derivative financial instruments consist predominantly of interest rate and cross currency swaps, and the Group used the relevant interest rate swap curves as of 30 June 2007 and 2006, and 31 December 2006 and 2005 to discount financial instruments. For Hong Kong dollars, interest rates used ranged from 4.474% to 5.301% (2006: 3.904% to 4.185%; 2005: 3.925% to 4.594%), U.S dollars from 5.358% to 5.879% (2006: 5.062% to 5.431%; 2005: 4.334% to 5.106%) and Euro from 4.216% to 5.018% (2006: 3.721% to 4.348%; 2005: 2.384% to 3.853%).

***B Financial risks***

The Group's operating activities and financing activities expose it to three main types of financial risks, namely interest rate risk, foreign exchange risk and credit risk. The Group's overall risk management programme focuses on the unpredictability of financial markets and seeks to minimise potential adverse effects on the Group's financial performance. The Group uses derivative financial instruments to hedge its exposure to interest rate and foreign exchange risks. These instruments are employed solely for hedging and not for trading or speculation purposes.

Risk management is carried out under policies approved by the Board of Directors. The Board provides written principles for overall risk management, as well as written policies covering specific areas, such as liquidity risk, interest rate risk, foreign exchange risk, credit risk, concentration risk, use of derivative financial instruments and non-derivative financial instruments, and investing excess liquidity. The Board regularly reviews these polices and authorises changes if necessary based on operating and market conditions and other relevant factors.

i *Liquidity risk*

Liquidity risk refers to the risk that funds will not be available to meet liabilities as they fall due, and it results from timing and amount mismatches of cash inflow and outflow. The Group adopts a prudent approach to managing liquidity risk by maintaining sufficient cash balances and an adequate amount of committed banking facilities at all times to provide forward coverage of all of its funding needs including working capital, debt refinancing, dividend payments, capital expenditures and new investments for a set minimum period of time of between 6 to 15 months.

ii *Interest rate risk*

The Group's interest rate risk arises from borrowings. Borrowings issued at fixed rates expose the Group to fair value interest rate risk whilst borrowings based on floating rates expose the Group to cash flow interest rate risk. The Group manages its exposure to interest rate risk by using mostly interest rate swaps.

iii *Foreign exchange risk*

Foreign exchange risk arises when recognised assets and liabilities are denominated in a currency that is not the Group's functional currency.

The Group manages its exposure to the foreign exchange risk by using mostly cross currency swaps and forward foreign exchange contracts.

iv *Credit risk*

Credit risk refers to the risk that a counterparty will be unable to pay amounts in full when due. For the Group, this arises mainly from the deposits it maintains and the derivative financial instruments that it has entered into with various banks and counterparties. To limit its exposure to credit risk, the Group places deposits and enters into derivative financial instruments only with financial institutions with acceptable credit ratings. For derivative financial instruments, the Group further quantifies and monitors its credit exposure by estimating the current fair market values and the potential change in fair market values of these instruments based on the "value-at-risk" concept.

v *Concentration risk*

The Group has no significant concentrations of credit risk with respect to the deposits it maintains and the derivative financial instruments it has entered into with various banks and counterparties. To reduce concentration risk, the Group assigns to each deposit-taking bank a credit rating based limit in accordance with credit policy approved by the Board. Pursuant to this policy, the Group also assigns mark-to-market limits to all its counterparties, and monitors the current and potential exposures due to derivative financial instruments against these limits.

## 28 Stores and spares

The Group

| | **At 31 December** | | | **At 30 June** | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Stores and spares expected to be consumed: | | | | | |
| — within 1 year | 156 | 137 | 142 | 161 | 138 |
| — after 1 year | 124 | 121 | 116 | 122 | 128 |
| | 280 | 258 | 258 | 283 | 266 |
| Less: Specific provision for obsolete stock | 8 | 10 | 10 | 6 | 5 |
| | 272 | 248 | 248 | 277 | 261 |

The Company

| | **At 31 December** | | | **At 30 June** | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Stores and spares expected to be consumed: | | | | | |
| — within 1 year | 156 | 137 | 142 | 159 | 138 |
| — after 1 year | 124 | 121 | 116 | 122 | 128 |
| | 280 | 258 | 258 | 281 | 266 |
| *Less:* Specific provision for obsolete stock | 8 | 10 | 10 | 6 | 5 |
| | 272 | 248 | 248 | 275 | 261 |

Stores and spares expected to be consumed after 1 year comprise mainly contingency spares and stocks kept to meet cyclical maintenance requirements.

## 29 Debtors, deposits and payments in advance

The Group

| *in HK$ million* | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 *(unaudited)* | At 30 June 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Debtors (net of specific impairment losses for bad and doubtful debts), deposits and payments in advance relate to: | | | | | |
| — Property development projects | 825 | 2,042 | 282 | 985 | 2,953 |
| — Railway operations and others | 1,069 | 1,053 | 994 | 972 | 1,014 |
| | 1,894 | 3,095 | 1,276 | 1,957 | 3,967 |

The Company

| *in HK$ million* | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 *(unaudited)* | At 30 June 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Debtors (net of specific impairment losses for bad and doubtful debts), deposits and payments in advance relate to: | | | | | |
| — Property development projects | 825 | 2,042 | 282 | 985 | 2,953 |
| — Railway operations and others | 957 | 933 | 989 | 881 | 926 |
| | 1,782 | 2,975 | 1,271 | 1,866 | 3,879 |

The Group's credit policy in respect of receivables arising from its principal activities are as follows:

i Rentals, advertising and telecommunications service fees are billed monthly with due dates ranging from 7 to 50 days. Tenants of the Group's investment properties and station kiosks are required to pay three months' rental deposit upon the signing of lease agreements.

ii Amounts receivable under interest rate and currency swap agreements with financial institutions are due in accordance with the respective terms of the agreements.

iii Consultancy services income are billed monthly and are due within 30 days.

iv Debtors in relation to contracts and capital works entrusted to the Group, subject to any agreed retentions, are due within 21 days upon the certification of work in progress.

v Amounts receivable from property purchasers are due in accordance with terms of respective sales and purchases agreements.

Fare revenue is collected either in cash for single and two-ride tickets or through Octopus Cards with daily settlement.

The ageing analysis of debtors included above is as follows:

The Group

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Amounts not yet due | 1,157 | 2,461 | 690 | 1,183 | 3,384 |
| Overdue by 30 days | 102 | 107 | 106 | 135 | 97 |
| Overdue by 60 days | 18 | 26 | 20 | 32 | 3 |
| Overdue by 90 days | 6 | 35 | 6 | 6 | 5 |
| Overdue by more than 90 days | 150 | 17 | 70 | 137 | 24 |
| Total debtors | 1,433 | 2,646 | 892 | 1,493 | 3,513 |
| Deposits and payments in advance | 342 | 348 | 286 | 326 | 342 |
| Prepaid pension costs | 119 | 101 | 98 | 138 | 112 |
| | 1,894 | 3,095 | 1,276 | 1,957 | 3,967 |

The Company

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Amounts not yet due | 1,145 | 2,448 | 681 | 1,168 | 3,371 |
| Overdue by 30 days | 96 | 61 | 103 | 128 | 86 |
| Overdue by 60 days | 17 | 24 | 14 | 30 | 2 |
| Overdue by 90 days | 4 | 6 | 6 | 5 | 4 |
| Overdue by more than 90 days | 143 | 12 | 70 | 135 | 19 |
| Total debtors | 1,405 | 2,551 | 874 | 1,466 | 3,482 |
| Deposits and payments in advance | 258 | 323 | 299 | 262 | 285 |
| Prepaid pension costs | 119 | 101 | 98 | 138 | 112 |
| | 1,782 | 2,975 | 1,271 | 1,866 | 3,879 |

Included in amounts not yet due are HK$137 million (2006: HK$478 million; 2005: HK$46 million; 2004: HK$56 million) receivable from certain stakeholding funds (note 18C) awaiting finalisation of the respective development accounts.

As at 30 June 2007, all debtors, deposits and payments in advance were expected to be recovered within one year except for HK$131 million (2006: HK$160 million; 2005: HK$168 million; 2004: HK$161 million) included in the amounts relating to deposits and receivables in respect of railway operations and others, which were expected to be recovered between one to three years. The nominal values less impairment losses for bad and doubtful debts are not discounted as it is considered that the effect of discounting would not be significant.

Included in debtors, deposits and payments in advance are the following amounts denominated in a currency other than the functional currency of the entity to which they relate:

The Group

| *in $ million* | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 *(unaudited)* | At 30 June 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Euro | 1 | 2 | 1 | 1 | 1 |
| Japanese Yen | — | 1 | — | — | — |
| New Taiwan dollar | 37 | 13 | 4 | 36 | 59 |
| Pataca | — | 2 | 9 | — | — |
| Pound sterling | 1 | — | — | — | 1 |
| United States dollar | 25 | 22 | 24 | 21 | 23 |
| Won | 1 | — | — | — | — |

The Company

| *in $ million* | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 *(unaudited)* | At 30 June 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Euro | 1 | 2 | 1 | 1 | 1 |
| Japanese Yen | — | 1 | — | — | — |
| New Taiwan dollar | 37 | 13 | 4 | 36 | 59 |
| Pataca | — | 2 | 9 | — | — |
| Pound sterling | — | — | — | — | — |
| United States dollar | 24 | 22 | 24 | 21 | 23 |
| Won | 1 | — | — | — | — |

## 30 Loan to a property developer

The Group and The Company

| | At 31 December | | | | | |
|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2004 | |
| *in HK$ million* | Nominal amount | Carrying amount | Nominal amount | Carrying amount | Nominal amount | Carrying amount |
| Interest-free loan to a property developer | 4,000 | 3,355 | — | — | — | — |

The Group and The Company

| | At 30 June | | | |
|---|---|---|---|---|
| | **2007** *(unaudited)* | | **2006** *(unaudited)* | |
| *in HK$ million* | **Nominal amount** | **Carrying amount** | **Nominal amount** | **Carrying amount** |
| Interest-free loan to a property developer | 4,000 | 3,442 | 4,000 | 3,268 |

The loan was provided to the developer of Package 2, Tseung Kwan O Area 86 property development project under the terms of the development agreement. The loan is interest-free and guaranteed by the developer's ultimate holding company and is repayable on completion of the respective phases of the project.

The difference between the nominal and carrying amount of the loan at inception, amounting to HK$768 million, was capitalised as property development in progress.

## 31 Amounts due from the Government and other related parties

The Group

| | **At 31 December** | | | **At 30 June** | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Amounts due from: | | | | | |
| — the Government | 40 | 27 | 36 | 34 | 26 |
| — the Housing Authority | 22 | 22 | 10 | 22 | 22 |
| — the Kowloon-Canton Railway Corporation ("KCRC") | 3 | 2 | — | 9 | — |
| — non-controlled subsidiaries | 94 | 88 | 87 | 92 | 88 |
| — associates | 18 | — | — | 26 | 29 |
| Loans to associates | — | 15 | — | — | 5 |
| | 177 | 154 | 133 | 183 | 170 |

The Company

| in HK$ million | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 (unaudited) | At 30 June 2006 (unaudited) |
|---|---|---|---|---|---|
| Amounts due from: | | | | | |
| — the Government | 40 | 27 | 36 | 34 | 26 |
| — the Housing Authority | 22 | 22 | 10 | 22 | 22 |
| — KCRC | 3 | 2 | — | 9 | — |
| — non-controlled subsidiaries | 94 | 88 | 87 | 92 | 88 |
| — associates | 18 | — | — | 26 | 29 |
| — other subsidiaries of the Company (net of impairment losses) | 523 | 285 | 142 | 748 | 518 |
| Loans to associates | — | — | — | — | 5 |
| | 700 | 424 | 275 | 931 | 688 |

The amount due from the Government relates to outstanding receivables and retention, as well as provision for contract claims recoverable from the Government, in connection with infrastructure works entrusted to the Company.

The amount due from the Housing Authority relates to site formation works entrusted to the Company by the Housing Authority in respect of the Tseung Kwan O Extension Project.

The amount due from KCRC relates to works entrusted to the Company in connection with the provision of interchange stations between the MTR and KCRC systems.

As at 30 June 2007, contract retentions on the above entrusted works due for release after one year were HK$12 million (2006: nil; 2005: nil; 2004: HK$4 million). All other amounts due from the Government and other related parties were expected to be received within 12 months.

The nominal values of amounts due from the Government and other related parties are considered not significantly different from their fair values as the amounts due are expected to be substantially settled within 24 months. The loans to associates are interest bearing at floating market rates, which are similar to the Company's discount rate. The carrying values of the loans are considered to approximate their fair values.

### 32 Cash and cash equivalents

The Group

| in HK$ million | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 (unaudited) | At 30 June 2006 (unaudited) |
|---|---|---|---|---|---|
| Deposits with banks and other financial institutions | 34 | 53 | 84 | 56 | 18 |
| Cash at banks and on hand | 276 | 306 | 185 | 357 | 351 |
| Cash and cash equivalents in the balance sheet | 310 | 359 | 269 | 413 | 369 |
| Bank overdrafts (note 33B) | (5) | (14) | (11) | (1) | (12) |
| Cash and cash equivalents in the cash flow statement | 305 | 345 | 258 | 412 | 357 |

The Company

| in HK$ million | At 31 December 2006 | 2005 | 2004 | At 30 June 2007 (unaudited) | 2006 (unaudited) |
|---|---|---|---|---|---|
| Deposits with banks and other financial institutions | 34 | 53 | 84 | 56 | 18 |
| Cash at banks and on hand | 93 | 63 | 53 | 151 | 51 |
| Cash and cash equivalents in the balance sheet | 127 | 116 | 137 | 207 | 69 |
| Bank overdrafts (note 33B) | (5) | (14) | (11) | (1) | (12) |
| Cash and cash equivalents in the cash flow statement | 122 | 102 | 126 | 206 | 57 |

During the six months ended 30 June 2007, the Group recognised deferred income and received properties as profit distribution in respect of property development of HK$1,087 million (2006: HK$3,833 million; 2005: HK$3,868 million; 2004: HK$3,013 million), which were transactions not involving movements of cash or cash equivalents.

Included in cash and cash equivalents in the balance sheet are the following amounts denominated in a currency other than the functional currency of the entity to which they relate:

The Group

| in $ million | At 31 December 2006 | 2005 | 2004 | At 30 June 2007 (unaudited) | 2006 (unaudited) |
|---|---|---|---|---|---|
| Euro | 2 | 2 | 7 | 2 | — |
| New Taiwan dollar | 22 | 63 | 31 | 31 | 15 |
| Pound sterling | — | — | 2 | 1 | — |
| Swiss franc | 2 | 2 | — | — | 2 |
| United States dollar | 8 | 14 | 4 | 5 | 15 |

The Company

| in $ million | At 31 December 2006 | 2005 | 2004 | At 30 June 2007 (unaudited) | 2006 (unaudited) |
|---|---|---|---|---|---|
| Euro | 2 | 2 | 7 | 2 | — |
| New Taiwan dollar | 22 | 63 | 31 | 31 | 15 |
| Pound sterling | — | — | 2 | 1 | — |
| Swiss franc | 2 | 2 | — | — | 2 |
| United States dollar | — | 2 | — | — | — |

**33 Loans and obligations under finance leases**

***A By type***

The Group

| | At 31 December | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2006 | | | 2005 | | | 2004 |
| *in HK$ million* | Carrying amount | Fair value | Repayable amount | Carrying amount | Fair value | Repayable amount | Repayable amount |
| **Capital market instruments** | | | | | | | |
| Listed or publicly traded: | | | | | | | |
| US dollar Yankee notes due 2005 | — | — | — | — | — | — | 2,324 |
| US dollar Global notes due 2009 | 5,651 | 6,100 | 5,834 | 5,711 | 6,253 | 5,834 | 5,834 |
| US dollar Global notes due 2010 | 4,511 | 5,056 | 4,679 | 4,582 | 5,176 | 4,679 | 4,679 |
| Debt issuance programme notes due 2005 | — | — | — | — | — | — | 194 |
| Debt issuance programme (Eurobond due 2014) | 4,380 | 4,565 | 4,663 | 4,514 | 4,605 | 4,663 | 4,663 |
| | 14,542 | 15,721 | 15,176 | 14,807 | 16,034 | 15,176 | 17,694 |
| Unlisted: | | | | | | | |
| Debt issuance programme notes due 2005 to 2020 | 7,046 | 7,383 | 7,075 | 5,976 | 6,226 | 6,021 | 4,918 |
| HK dollar notes due 2006 to 2008 | 515 | 512 | 500 | 1,526 | 1,520 | 1,500 | 1,500 |
| HK dollar retail bonds due 2005 to 2006 | — | — | — | 1,002 | 1,003 | 1,000 | 2,250 |
| | 7,561 | 7,895 | 7,575 | 8,504 | 8,749 | 8,521 | 8,668 |
| **Total capital market instruments** | 22,103 | 23,616 | 22,751 | 23,311 | 24,783 | 23,697 | 26,362 |
| **Bank loans** | 4,789 | 4,706 | 4,757 | 4,282 | 4,315 | 4,306 | 3,612 |
| **Obligations under finance leases (note 33C)** | 141 | 141 | 141 | 272 | 272 | 272 | 393 |
| **Loans and obligations under finance leases** | 27,033 | 28,463 | 27,649 | 27,865 | 29,370 | 28,275 | 30,367 |
| **Bank overdrafts** | 5 | 5 | 5 | 14 | 14 | 14 | 11 |
| **Short-term loans** | 1,114 | 1,114 | 1,114 | 385 | 385 | 385 | — |
| **Total** | 28,152 | 29,582 | 28,768 | 28,264 | 29,769 | 28,674 | 30,378 |

The Group

| *in HK$ million* | At 30 June 2007 (unaudited) Carrying amount | Fair value | Repayable amount | 2006 (unaudited) Carrying amount | Fair value | Repayable amount |
|---|---|---|---|---|---|---|
| **Capital market instruments** | | | | | | |
| Listed or publicly traded: | | | | | | |
| US dollar Global notes due 2009 | 5,718 | 6,051 | 5,834 | 5,650 | 6,085 | 5,834 |
| Us dollar Global notes due 2010 | 4,607 | 4,986 | 4,679 | 4,551 | 4,989 | 4,679 |
| Debt issuance programme (Eurobond due 2014) | 4,510 | 4,486 | 4,663 | 4,462 | 4,391 | 4,663 |
| | 14,835 | 15,523 | 15,176 | 14,663 | 15,465 | 15,176 |
| Unlisted: | | | | | | |
| Debt issuance programme notes due 2018 | 447 | 574 | 465 | 444 | 573 | 465 |
| Debt issuance programme notes due 2006 to 2020 | 6,513 | 6,429 | 6,632 | 5,926 | 5,831 | 6,058 |
| HK dollar notes due 2008 | 508 | 505 | 500 | 511 | 509 | 500 |
| | 7,468 | 7,508 | 7,597 | 6,881 | 6,913 | 7,023 |
| **Total capital market instruments** | 22,303 | 23,031 | 22,773 | 21,544 | 22,378 | 22,199 |
| **Bank loans** | 2,770 | 2,756 | 2,739 | 9,032 | 9,019 | 9,003 |
| **Obligations under finance leases (note 33C)** | 72 | 72 | 72 | 208 | 208 | 208 |
| **Loans and obligations under finance leases** | 25,145 | 25,859 | 25,584 | 30,784 | 31,605 | 31,410 |
| **Bank overdrafts** | 1 | 1 | 1 | 12 | 12 | 12 |
| **Short-term loans** | 24 | 24 | 24 | 1,013 | 1,013 | 1,013 |
| **Total** | 25,170 | 25,884 | 25,609 | 31,809 | 32,630 | 32,435 |

The Company

| *in HK$ million* | At 31 December 2006 Carrying amount | 2006 Fair value | 2006 Repayable amount | 2005 Carrying amount | 2005 Fair value | 2005 Repayable amount | 2004 Repayable amount |
|---|---|---|---|---|---|---|---|
| **Capital market instruments** | | | | | | | |
| Listed or publicly traded: | | | | | | | |
| US dollar Yankee notes due 2005 | — | — | — | — | — | — | 2,324 |
| US dollar Global notes due 2009 | 5,651 | 6,100 | 5,834 | 5,711 | 6,253 | 5,834 | 5,834 |
| US dollar Global notes due 2010 | 4,511 | 5,056 | 4,679 | 4,582 | 5,176 | 4,679 | 4,679 |
| Debt issuance programme notes due 2005 | — | — | — | — | — | — | 194 |
| | 10,162 | 11,156 | 10,513 | 10,293 | 11,429 | 10,513 | 13,031 |
| Unlisted: | | | | | | | |
| Debt issuance programme notes due 2005 to 2018 | 426 | 597 | 465 | 443 | 614 | 480 | 665 |
| | 426 | 597 | 465 | 443 | 614 | 480 | 665 |
| **Total capital market instruments** | 10,588 | 11,753 | 10,978 | 10,736 | 12,043 | 10,993 | 13,696 |
| **Bank loans** | 4,789 | 4,706 | 4,757 | 4,282 | 4,315 | 4,306 | 3,612 |
| **Obligations under finance leases (note 33C)** | 141 | 141 | 141 | 272 | 272 | 272 | 393 |
| **Loans and obligations under finance leases** | 15,518 | 16,600 | 15,876 | 15,290 | 16,630 | 15,571 | 17,701 |
| **Bank overdrafts** | 5 | 5 | 5 | 14 | 14 | 14 | 11 |
| **Short-term loans** | 1,114 | 1,114 | 1,114 | 385 | 385 | 385 | — |
| **Total** | 16,637 | 17,719 | 16,995 | 15,689 | 17,029 | 15,970 | 17,712 |

The Company

| in HK$ million | 2007 (unaudited) Carrying amount | 2007 (unaudited) Fair value | 2007 (unaudited) Repayable amount | 2006 (unaudited) Carrying amount | 2006 (unaudited) Fair value | 2006 (unaudited) Repayable amount |
|---|---|---|---|---|---|---|
| **Capital market instruments** | | | | | | |
| Listed or publicly traded: | | | | | | |
| US dollar Global notes due 2009 | 5,718 | 6,051 | 5,834 | 5,650 | 6,085 | 5,834 |
| US dollar Global notes due 2010 | 4,607 | 4,986 | 4,679 | 4,551 | 4,989 | 4,679 |
| | 10,325 | 11,037 | 10,513 | 10,201 | 11,074 | 10,513 |
| Unlisted: | | | | | | |
| Debt issuance programme notes due 2018 | 447 | 574 | 436 | 444 | 573 | 471 |
| | 447 | 574 | 436 | 444 | 573 | 471 |
| **Total capital market instruments** | 10,772 | 11,611 | 10,949 | 10,645 | 11,647 | 10,984 |
| **Bank loans** | 2,770 | 2,756 | 2,739 | 9,032 | 9,019 | 9,003 |
| **Obligations under finance leases (note 33C)** | 72 | 72 | 72 | 208 | 208 | 208 |
| **Loans and obligations under finance leases** | 13,614 | 14,439 | 13,760 | 19,885 | 20,874 | 20,195 |
| **Bank overdrafts** | 1 | 1 | 1 | 12 | 12 | 12 |
| **Short-term loans** | — | — | — | 1,013 | 1,013 | 1,013 |
| **Total** | 13,615 | 14,440 | 13,761 | 20,910 | 21,899 | 21,220 |

As at 30 June 2007, the Group had available undrawn committed bank loan facilities amounting to HK$6,300 million (2006: HK$5,700 million; 2005: HK$5,300 million; 2004: HK$5,815 million). In addition, the Group had a number of uncommitted facilities with undrawn amounts totalling HK$16,521 million (2006: HK$14,946 million; 2005: HK$8,851 million; 2004: HK$10,536 million), comprising a debt issuance programme and short-term bank loan facilities.

The fair values are based on the discounted cash flows method which discounts the future contractual cash flows at the current market interest and foreign exchange rates that is available to the Group for similar financial instruments.

The Group's derivative financial instruments consist predominantly of interest rate and cross currency swaps, and the Group used the relevant interest rate swap curves as of 30 June 2007 and 2006, and 31 December 2006 and 2005 to discount financial instruments. For Hong Kong dollars, interest rates used ranged from 4.474% to 5.301% (2006: 3.904% to 4.185%; 2005: 3.925% to 4.594%), U.S dollars from 5.358% to 5.879% (2006: 5.062% to 5.431%; 2005: 4.334% to 5.106%) and Euro from 4.216% to 5.018% (2006: 3.721% to 4.348%; 2005: 2.384% to 3.853%).

The carrying amounts of short-term loans and overdrafts approximated their fair values.

The amounts of borrowings, denominated in a currency other than the functional currency of the entity to which they relate, before and after currency hedging activities are as follows:

| | Before hedging activities | | | | | After hedging activities | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | At 31 December | | | At 30 June | | At 31 December | | | At 30 June | |
| *in $ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| The Group | | | | | | | | | | |
| Euro | 10 | 13 | 15 | 9 | 11 | — | — | — | — | — |
| United States dollar | 2,118 | 2,120 | 2,447 | 2,117 | 2,119 | 8 | 10 | 12 | 7 | 9 |
| The Company | | | | | | | | | | |
| Euro | 10 | 13 | 15 | 9 | 11 | — | — | — | — | — |
| United States dollar | 1,418 | 1,420 | 1,747 | 1,417 | 1,419 | 8 | 10 | 12 | 7 | 9 |

## B *By repayment terms*

The Group

| | At 31 December | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2006 | | | | 2005 | | | | 2004 |
| *in HK$ million* | **Capital market instruments** | **Bank loans and overdrafts** | **Obligations under finance leases** | **Total** | **Capital market instruments** | **Bank loans and overdrafts** | **Obligations under finance leases** | **Total** | **Total** |
| **Long-term loans and obligations under finance leases** | | | | | | | | | |
| Amounts repayable beyond 5 years | 10,088 | 600 | — | 10,688 | 10,084 | 916 | — | 11,000 | 13,502 |
| Amounts repayable within a period of between 2 and 5 years | 11,663 | 2,092 | — | 13,755 | 11,163 | 2,178 | — | 13,341 | 9,070 |
| Amounts repayable within a period of between 1 and 2 years | 1,000 | 2,030 | — | 3,030 | — | 606 | 141 | 747 | 3,186 |
| Amounts repayable within 1 year | — | 35 | 141 | 176 | 2,450 | 606 | 131 | 3,187 | 4,609 |
| | 22,751 | 4,757 | 141 | 27,649 | 23,697 | 4,306 | 272 | 28,275 | 30,367 |
| **Bank overdrafts** | — | 5 | — | 5 | — | 14 | — | 14 | 11 |
| **Short-term loans** | — | 1,114 | — | 1,114 | — | 385 | — | 385 | — |
| | 22,751 | 5,876 | 141 | 28,768 | 23,697 | 4,705 | 272 | 28,674 | 30,378 |
| *Less:* Unamortised discount/premium/ finance charges outstanding | (103) | (3) | — | (106) | (118) | (5) | — | (123) | |
| Adjustment due to fair value change of financial instruments | (545) | 35 | — | (510) | (268) | (19) | — | (287) | |
| **Total carrying amount of debt** | 22,103 | 5,908 | 141 | 28,152 | 23,311 | 4,681 | 272 | 28,264 | |

The Group

| *in HK$ million* | At 30 June 2007 (unaudited) Capital market instruments | Bank loans and overdrafts | Obligations under finance leases | Total | At 30 June 2006 (unaudited) Capital market instruments | Bank loans and overdrafts | Obligations under finance leases | Total |
|---|---|---|---|---|---|---|---|---|
| **Long-term loans and obligations under finance leases** | | | | | | | | |
| Amounts repayable beyond 5 years | 10,110 | — | — | 10,110 | 10,086 | 1,600 | — | 11,686 |
| Amounts repayable within a period of between 2 and 5 years | 5,829 | 1,739 | — | 7,568 | 10,663 | 4,455 | — | 15,118 |
| Amounts repayable within a period of between 1 and 2 years | 5,834 | 630 | — | 6,464 | 1,000 | 2,341 | 72 | 3,413 |
| Amounts repayable within 1 year | 1,000 | 370 | 72 | 1,442 | 450 | 607 | 136 | 1,193 |
| | 22,773 | 2,739 | 72 | 25,584 | 22,199 | 9,003 | 208 | 31,410 |
| **Bank overdrafts** | — | 1 | — | 1 | — | 12 | — | 12 |
| **Short-term loans** | — | 24 | — | 24 | — | 1,013 | — | 1,013 |
| | 22,773 | 2,764 | 72 | 25,609 | 22,199 | 10,028 | 208 | 32,435 |
| *Less:* Unamortised discount/premium/finance charges outstanding | (113) | (2) | — | (115) | (111) | (6) | — | (117) |
| Adjustment due to fair value change of financial instruments | (357) | 33 | — | (324) | (544) | 35 | — | (509) |
| **Total carrying amount of debt** | 22,303 | 2,795 | 72 | 25,170 | 21,544 | 10,057 | 208 | 31,809 |

The Company

| *in HK$ million* | **2006 Capital market instruments** | **2006 Bank loans and overdrafts** | **2006 Obligations under finance leases** | **2006 Total** | **2005 Capital market instruments** | **2005 Bank loans and overdrafts** | **2005 Obligations under finance leases** | **2005 Total** | **2004 Total** |
|---|---|---|---|---|---|---|---|---|---|
| **Long-term loans and obligations under finance leases** | | | | | | | | | |
| Amounts repayable beyond 5 years | 465 | 600 | — | 1,065 | 480 | 916 | — | 1,396 | 5,236 |
| Amounts repayable within a period of between 2 and 5 years | 10,513 | 2,092 | — | 12,605 | 10,513 | 2,178 | — | 12,691 | 8,570 |
| Amounts repayable within a period of between 1 and 2 years | — | 2,030 | — | 2,030 | — | 606 | 141 | 747 | 736 |
| Amounts repayable within 1 year | — | 35 | 141 | 176 | — | 606 | 131 | 737 | 3,159 |
| | 10,978 | 4,757 | 141 | 15,876 | 10,993 | 4,306 | 272 | 15,571 | 17,701 |
| **Bank overdrafts** | — | 5 | — | 5 | — | 14 | — | 14 | 11 |
| **Short-term loans** | — | 1,114 | — | 1,114 | — | 385 | — | 385 | — |
| | 10,978 | 5,876 | 141 | 16,995 | 10,993 | 4,705 | 272 | 15,970 | 17,712 |
| *Less:* Unamortised discount/premium/finance charges outstanding | (51) | (3) | — | (54) | (65) | (5) | — | (70) | |
| Adjustment due to fair value change of financial instruments | (339) | 35 | — | (304) | (192) | (19) | — | (211) | |
| **Total carrying amount of debt** | 10,588 | 5,908 | 141 | 16,637 | 10,736 | 4,681 | 272 | 15,689 | |

The Company

| in HK$ million | At 30 June 2007 (unaudited) Capital market instruments | Bank loans and overdrafts | Obligations under finance leases | Total | At 30 June 2006 (unaudited) Capital market instruments | Bank loans and overdrafts | Obligations under finance leases | Total |
|---|---|---|---|---|---|---|---|---|
| **Long-term loans and obligations under finance leases** | | | | | | | | |
| Amounts repayable beyond 5 years | 436 | — | — | 436 | 471 | 1,600 | — | 2,071 |
| Amounts repayable within a period of between 2 and 5 years | 4,679 | 1,739 | — | 6,418 | 10,513 | 4,455 | — | 14,968 |
| Amounts repayable within a period of between 1 and 2 years | 5,834 | 630 | — | 6,464 | — | 2,341 | 72 | 2,413 |
| Amounts repayable within 1 year | — | 370 | 72 | 442 | — | 607 | 136 | 743 |
| | 10,949 | 2,739 | 72 | 13,760 | 10,984 | 9,003 | 208 | 20,195 |
| **Bank overdrafts** | — | 1 | — | 1 | — | 12 | — | 12 |
| **Short-term loans** | — | — | — | — | — | 1,013 | — | 1,013 |
| | 10,949 | 2,740 | 72 | 13,761 | 10,984 | 10,028 | 208 | 21,220 |
| *Less:* Unamortised discount/premium/finance charges outstanding | (44) | (2) | — | (46) | (58) | (6) | — | (64) |
| Adjustment due to fair value change of financial instruments | (133) | 33 | — | (100) | (281) | 35 | — | (246) |
| **Total carrying amount of debt** | 10,772 | 2,771 | 72 | 13,615 | 10,645 | 10,057 | 208 | 20,910 |

The amounts repayable within 1 year in respect of long-term loans and obligations under finance leases are included in long-term loans as these amounts are intended to be refinanced on a long-term basis.

### C *Obligations under finance leases*

As at 30 June 2007, the Group and the Company had obligations under finance leases repayable as follows:

The Group and The Company

| *in HK$ million* | At 31 December 2006 Present value of the minimum lease payments | 2006 Interest expense relating to future periods | 2006 Total minimum lease payments | 2005 Present value of the minimum lease payments | 2005 Interest expense relating to future periods | 2005 Total minimum lease payments | 2004 Present value of the minimum lease payments | 2004 Interest expense relating to future periods | 2004 Total minimum lease payments |
|---|---|---|---|---|---|---|---|---|---|
| Amounts repayable within a period of between 2 and 5 years | — | — | — | — | — | — | 141 | 9 | 150 |
| Amounts repayable within a period of between 1 and 2 years | — | — | — | 141 | 9 | 150 | 131 | 19 | 150 |
| Amounts repayable within 1 year | 141 | 9 | 150 | 131 | 19 | 150 | 121 | 29 | 150 |
| | 141 | 9 | 150 | 272 | 28 | 300 | 393 | 57 | 450 |

| *in HK$ million* | At 30 June 2007 (unaudited) Present value of the minimum lease payments | 2007 Interest expense relating to future periods | 2007 Total minimum lease payments | 2006 (unaudited) Present value of the minimum lease payments | 2006 Interest expense relating to future periods | 2006 Total minimum lease payments |
|---|---|---|---|---|---|---|
| Amounts repayable within a period of between 1 and 2 years | — | — | — | 72 | 3 | 75 |
| Amounts repayable within 1 year | 72 | 3 | 75 | 136 | 14 | 150 |
| | 72 | 3 | 75 | 208 | 17 | 225 |

Obligations under finance lease are the Group's and the Company's commitments to make future payments to New Hong Kong Tunnel Company Limited under the agreement for the Eastern Harbour Crossing which is treated as a finance lease (note 16E).

***D Bonds and notes issued and redeemed***

Bonds and notes issued during the year/period comprise:

The Group

| *in HK$ million* | **Year ended 31 December** | | | | | |
|---|---|---|---|---|---|---|
| | **2006** | | **2005** | | **2004** | |
| | **Principal amount** | **Net consideration received** | **Principal amount** | **Net consideration received** | **Principal amount** | **Net consideration received** |
| Debt issuance programme notes | 1,500 | 1,499 | 1,500 | 1,491 | 5,158 | 5,109 |

| *in HK$ million* | **Six months ended 30 June** | | | |
|---|---|---|---|---|
| | **2007** *(unaudited)* | | **2006** *(unaudited)* | |
| | **Principal amount** | **Net consideration received** | **Principal amount** | **Net consideration received** |
| Debt issuance programme notes | — | — | 500 | 499 |

The above notes were issued by a subsidiary, MTR Corporation (C.I.) Limited. The notes issued are unconditionally and irrevocably guaranteed by the Company; and are direct, unsecured, unconditional and unsubordinated to other unsecured and unsubordinated obligations of MTR Corporation (C.I.) Limited. The obligations of the Company under the guarantee are direct, unsecured, unconditional, and unsubordinated to other unsecured and unsubordinated obligations of the Company. The net proceeds received from the issues were on lent to the Company for general working capital, refinancing or other corporate purposes.

During the six months ended 30 June 2007, none of the Group's unlisted debt securities was redeemed (2006: HK$2,450 million; 2005: HK1,650 million; 2004: HK4,415 million).

During the six months ended 30 June 2007, none of the Group's listed debt securities was redeemed (2006: nil; 2005: HK$2,518 million; 2004: nil).

***E Guarantees***

There were no guarantees given by the Government in respect of loan facilities as at 30 June 2007 and 2006, and 31 December 2006, 2005 and 2004.

***F Interest rates***

Outstanding amount of total borrowings, excluding obligations under finance leases, of HK$25,098 million (2006: HK$28,011 million; 2005: HK$27,992 million; 2004: HK29,985 million) comprise:

The Group

| | Fixed rate borrowings and borrowings swapped to fixed rates | | Variable rate borrowings and borrowings swapped from fixed rate | |
|---|---|---|---|---|
| | **Carrying amount** | **Interest rate** | **Carrying amount** | **Interest rate** |
| | *HK$ million* | *% p.a.* | *HK$ million* | *% p.a.* |
| **At 31 December 2006** | | | | |
| Amounts repayable beyond 5 years | 7,667 | 4.2 - 8.4 | 2,711 | (Note) |
| Amounts repayable within a period of between 2 and 5 years | 7,517 | 4.2 - 7.5 | 5,904 | |
| Amounts repayable within a period of between 1 and 2 years | 1,207 | 3.1 - 5.5 | 1,844 | |
| Amounts repayable within 1 year | 557 | 4.9 - 5.5 | 604 | |
| | 16,948 | | 11,063 | 3.1 - 7.3 |
| **At 31 December 2005** | | | | |
| Amounts repayable beyond 5 years | 6,635 | 4.3 - 8.4 | 4,169 | (Note) |
| Amounts repayable within a period of between 2 and 5 years | 7,528 | 3.1 - 7.5 | 5,594 | |
| Amounts repayable within a period of between 1 and 2 years | 557 | 4.9 - 5.5 | 45 | |
| Amounts repayable within 1 year | 3,409 | 2.2 - 5.5 | 55 | |
| | 18,129 | | 9,863 | 3.3 - 6.2 |
| **At 31 December 2004** | | | | |
| Amounts repayable beyond 5 years | 9,225 | 4.5 - 8.4 | 4,277 | (Note) |
| Amounts repayable within a period of between 2 and 5 years | 4,382 | 3.1 - 7.5 | 4,547 | |
| Amounts repayable within a period of between 1 and 2 years | 3,408 | 2.2 - 5.5 | (353) | |
| Amounts repayable within 1 year | 4,944 | 4.4 - 8.0 | (445) | |
| | 21,959 | | 8,026 | 0.3 - 3.7 |
| **At 30 June 2007 (unaudited)** | | | | |
| Amounts repayable beyond 5 years | 7,836 | 4.2 - 8.4 | 1,988 | (Note) |
| Amounts repayable within a period of between 2 and 5 years | 4,616 | 4.2 - 7.5 | 2,891 | |
| Amounts repayable within a period of between 1 and 2 years | 3,778 | 3.1 - 7.5 | 2,578 | |
| Amounts repayable within 1 year | 507 | 4.3 - 5.5 | 904 | |
| | 16,737 | | 8,361 | 3.7 - 7.2 |

The Group

| | Fixed rate borrowings and borrowings swapped to fixed rates | | Variable rate borrowings and borrowings swapped from fixed rate | |
|---|---|---|---|---|
| | **Carrying amount** | **Interest rate** | **Carrying amount** | **Interest rate** |
| | *HK$ million* | *% p.a.* | *HK$ million* | *% p.a.* |
| **At 30 June 2006 (unaudited)** | | | | |
| Amounts repayable beyond 5 years | 6,634 | 4.3 - 8.4 | 4,702 | (Note) |
| Amounts repayable within a period of between 2 and 5 years | 7,520 | 3.1 - 7.5 | 7,298 | |
| Amounts repayable within a period of between 1 and 2 years | 507 | 4.3 - 5.5 | 2,850 | |
| Amounts repayable within 1 year | 2,357 | 2.2 - 5.5 | (267) | |
| | 17,018 | | 14,583 | 3.6 - 6.7 |

The Company

| | Fixed rate borrowings and borrowings swapped to fixed rates | | Variable rate borrowings and borrowings swapped from fixed rate | |
|---|---|---|---|---|
| | **Carrying amount** | **Interest rate** | **Carrying amount** | **Interest rate** |
| | *HK$ million* | *% p.a.* | *HK$ million* | *% p.a.* |
| **At 31 December 2006** | | | | |
| Amounts repayable beyond 5 years | 1,590 | 4.2 - 8.4 | (562) | (Note) |
| Amounts repayable within a period of between 2 and 5 years | 7,517 | 4.3 - 7.5 | 4,754 | |
| Amounts repayable within a period of between 1 and 2 years | 707 | 3.1 - 5.5 | 1,329 | |
| Amounts repayable within 1 year | 557 | 4.9 - 5.5 | 604 | |
| | 10,371 | | 6,125 | 3.1 - 7.3 |
| **At 31 December 2005** | | | | |
| Amounts repayable beyond 5 years | 447 | 5.5 - 8.4 | 911 | (Note) |
| Amounts repayable within a period of between 2 and 5 years | 7,528 | 3.1 - 7.5 | 4,928 | |
| Amounts repayable within a period of between 1 and 2 years | 557 | 4.9 - 5.5 | 45 | |
| Amounts repayable within 1 year | 2,407 | 2.2 - 5.5 | (1,406) | |
| | 10,939 | | 4,478 | 3.3 - 6.2 |

The Company

| | Fixed rate borrowings and borrowings swapped to fixed rates | | Variable rate borrowings and borrowings swapped from fixed rate | |
|---|---|---|---|---|
| | **Carrying amount** | **Interest rate** | **Carrying amount** | **Interest rate** |
| | *HK$ million* | *% p.a.* | *HK$ million* | *% p.a.* |
| **At 31 December 2004** | | | | |
| Amounts repayable beyond 5 years | 958 | 5.5 - 8.4 | 4,278 | (Note) |
| Amounts repayable within a period of between 2 and 5 years | 3,883 | 3.1 - 7.5 | 4,546 | |
| Amounts repayable within a period of between 1 and 2 years | 958 | 2.2 - 5.5 | (353) | |
| Amounts repayable within 1 year | 3,494 | 4.4 - 8.0 | (445) | |
| | 9,293 | | 8,026 | 0.3 - 3.7 |
| **At 30 June 2007 (unaudited)** | | | | |
| Amounts repayable beyond 5 years | 1,609 | 4.2 - 8.4 | (1,162) | (Note) |
| Amounts repayable within a period of between 2 and 5 years | 4,616 | 4.3 - 7.5 | 1,746 | |
| Amounts repayable within a period of between 1 and 2 years | 3,778 | 3.1 - 7.5 | 2,577 | |
| Amounts repayable within 1 year | 7 | 5.5 - 5.5 | 372 | |
| | 10,010 | | 3,533 | 3.7 - 7.2 |
| **At 30 June 2006 (unaudited)** | | | | |
| Amounts repayable beyond 5 years | 444 | 5.5 - 8.4 | 1,600 | (Note) |
| Amounts repayable within a period of between 2 and 5 years | 7,520 | 3.1 - 7.5 | 7,154 | |
| Amounts repayable within a period of between 1 and 2 years | 8 | 5.5 - 5.5 | 2,339 | |
| Amounts repayable within 1 year | 2,357 | 2.2 - 5.5 | (720) | |
| | 10,329 | | 10,373 | 3.6 - 6.7 |

*Note:* In respect of the variable rate borrowings and borrowings swapped from fixed rate, the interest rates quoted are their contract rates as at balance sheet date subject to repricing in less than one year.

## 34 Creditors, accrued charges and provisions

The Group

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Creditors, accrued charges and provisions | | | | | |
| — Airport Railway Project | 79 | 87 | 89 | 72 | 79 |
| — Tseung Kwan O Extension Project | 152 | 155 | 223 | 149 | 156 |
| — Property projects and management | 1,263 | 1,112 | 945 | 3,359 | 1,635 |
| — Railway operations and others | 2,089 | 2,005 | 1,833 | 1,889 | 1,774 |
| Gross amount due to customers for contract work | 56 | 56 | 56 | 56 | 56 |
| | 3,639 | 3,415 | 3,146 | 5,525 | 3,700 |

The Company

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Creditors, accrued charges and provisions | | | | | |
| — Airport Railway Project | 79 | 87 | 89 | 72 | 79 |
| — Tseung Kwan O Extension Project | 152 | 155 | 223 | 149 | 156 |
| — Property projects and management | 1,263 | 1,112 | 945 | 3,359 | 1,635 |
| — Railway operations and others | 1,709 | 1,676 | 1,554 | 1,547 | 1,509 |
| Gross amount due to customers for contract work | 56 | 56 | 56 | 56 | 56 |
| | 3,259 | 3,086 | 2,867 | 5,183 | 3,435 |

The above amounts are mainly related to capital projects which are settled upon certification of work in progress, swap interest payable and forward sale deposits received in respect of properties for which occupation permits have not been issued. The Group has no significant balances of trade creditors resulting from its provision of transportation services.

As at 30 June 2007, the aggregate amount of costs incurred plus recognised profits less recognised losses to date, included in the gross amount due to customers for contract work, was HK$207 million (2006: HK$179 million; 2005: HK$130 million; 2004: HK$58 million).

The gross amount due to customers for contract work at 30 June 2007 that is expected to be settled after more than one year is HK$56 million (2006: HK$56 million; 2005: HK$56 million; 2004: HK$56 million).

The analysis of creditors included above by due dates is as follows:

The Group

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Due within 30 days or on demand | 645 | 591 | 563 | 609 | 606 |
| Due after 30 days but within 60 days | 651 | 643 | 509 | 485 | 499 |
| Due after 60 days but within 90 days | 103 | 116 | 106 | 80 | 125 |
| Due after 90 days | 1,472 | 1,430 | 1,415 | 1,490 | 1,784 |
| | 2,871 | 2,780 | 2,593 | 2,664 | 3,014 |
| Rental, forward sale and other refundable deposits | 631 | 498 | 419 | 2,723 | 545 |
| Accrued employee benefits | 137 | 137 | 134 | 138 | 141 |
| Total | 3,639 | 3,415 | 3,146 | 5,525 | 3,700 |

The Company

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Due within 30 days or on demand | 456 | 459 | 414 | 451 | 480 |
| Due after 30 days but within 60 days | 589 | 601 | 474 | 427 | 456 |
| Due after 60 days but within 90 days | 97 | 104 | 105 | 61 | 94 |
| Due after 90 days | 1,377 | 1,293 | 1,321 | 1,413 | 1,730 |
| | 2,519 | 2,457 | 2,314 | 2,352 | 2,760 |
| Rental, forward sale and other refundable deposits | 603 | 492 | 419 | 2,693 | 534 |
| Accrued employee benefits | 137 | 137 | 134 | 138 | 141 |
| Total | 3,259 | 3,086 | 2,867 | 5,183 | 3,435 |

Creditors, accrued charges and provisions in respect of the capital projects and other construction works include provisions for claims on completed contracts, which were capitalised as part of the related assets. Most of these claims have been resolved and it is anticipated that, subject to unforeseen circumstances, the remaining amount required to be paid will be sufficiently covered by the above mentioned provisions of the respective projects. The carrying amounts of such claim provisions and their movements are not separately disclosed in view of their commercial sensitivity.

As at 30 June 2007, all creditors, accrued charges and provisions were expected to be settled within one year except for HK$452 million (2006: HK$512 million; 2005: HK$463 million; 2004: HK$350 million) included in the amounts relating to railway operations and others, which were expected to be settled after one year. The amounts due after one year are mainly rental deposits received from shop and station kiosk tenants and advance income received from telecommunication services operators, majority of which are due to be repaid within three years. The Group considers the effect of discounting these deposits would be immaterial.

The nominal values of creditors, accrued charges and provisions are not significantly different from their fair values.

Included in creditors, accrued charges and provisions are the following amounts denominated in a currency other than the functional currency of the entity to which they relate:

The Group

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in $ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Euro | 3 | 3 | 5 | 1 | 2 |
| Japanese Yen | 5 | 2 | 1 | 23 | 58 |
| New Taiwan dollar | 3 | — | 1 | 2 | 1 |
| Pound sterling | 1 | 1 | — | 1 | 1 |
| Swiss franc | 1 | 1 | 2 | — | — |
| United States dollar | 53 | 51 | 55 | 49 | 52 |
| Won | — | 2 | — | — | 2 |

The Company

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in $ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Euro | 3 | 3 | 5 | 1 | 2 |
| Japanese Yen | 5 | 2 | 1 | 23 | 58 |
| New Taiwan dollar | 3 | — | 1 | 2 | 1 |
| Pound sterling | 1 | 1 | — | 1 | 1 |
| Swiss franc | 1 | 1 | 2 | — | — |
| United States dollar | 39 | 37 | 40 | 35 | 37 |
| Won | — | 2 | — | — | 2 |

## 35 Contract retentions

| | The Group | | | The Company | | |
|---|---|---|---|---|---|---|
| *in HK$ million* | **Due for release after 12 months** | **Due for release within 12 months** | **Total** | **Due for release after 12 months** | **Due for release within 12 months** | **Total** |
| **At 31 December 2006** | | | | | | |
| Railway extension projects | 19 | 48 | 67 | 19 | 46 | 65 |
| Railway operations | 34 | 92 | 126 | 34 | 92 | 126 |
| | 53 | 140 | 193 | 53 | 138 | 191 |
| **At 31 December 2005** | | | | | | |
| Railway extension projects | 7 | 63 | 70 | 7 | 63 | 70 |
| Railway operations | 9 | 91 | 100 | 9 | 91 | 100 |
| | 16 | 154 | 170 | 16 | 154 | 170 |
| **At 31 December 2004** | | | | | | |
| Railway extension projects | 50 | 99 | 149 | 50 | 99 | 149 |
| Railway operations | 21 | 70 | 91 | 21 | 70 | 91 |
| | 71 | 169 | 240 | 71 | 169 | 240 |
| **At 30 June 2007 (unaudited)** | | | | | | |
| Railway extension projects | 28 | 26 | 54 | 28 | 18 | 46 |
| Railway operations | 29 | 77 | 106 | 29 | 77 | 106 |
| | 57 | 103 | 160 | 57 | 95 | 152 |
| **At 30 June 2006 (unaudited)** | | | | | | |
| Railway extension projects | 7 | 58 | 65 | 7 | 56 | 63 |
| Railway operations | 38 | 68 | 106 | 38 | 68 | 106 |
| | 45 | 126 | 171 | 45 | 124 | 169 |

The effect of discounting these contract retentions is considered immaterial as these amounts are substantially due to be released within 24 months.

Included in contract retentions are the following amounts denominated in a currency other than the functional currency of the entity to which they relate:

The Group

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in $ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Swiss franc | 3 | 3 | 3 | 1 | 3 |

The Company

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in $ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Swiss franc | 3 | 3 | 3 | 1 | 3 |

## 36 Amounts due to related parties

The followings are amounts due to the subsidiaries and other related Group companies:

The Group

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Amounts due to: | | | | | |
| — KCRC | — | — | 1 | — | 2 |
| — associates | — | 17 | — | — | — |
| | — | 17 | 1 | — | 2 |

The Company

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Amounts due to: | | | | | |
| — KCRC | — | — | 1 | — | 2 |
| — subsidiaries | 11,718 | 12,773 | 12,870 | 11,687 | 11,059 |
| | 11,718 | 12,773 | 12,871 | 11,687 | 11,061 |

As at 30 June 2007, amounts due to the subsidiaries of HK$11,531 million (2006: HK$11,515 million; 2005: HK$12,773 million; 2004: HK$12,665 million) were expected to be settled after one year.

Amounts due to the Company's subsidiaries includes HK$11,684 million (2006: HK$11,704 million; 2005: HK$12,773 million; 2004: HK$12,863 million) due to MTR Corporation (C.I.) Limited in respect of proceeds from bonds and notes issued by the subsidiary, which were on-lent to the Company for its general corporate purposes with specified repayment dates and interest rates (note 33D), and accrued interest. These amounts are stated at their fair values. The remaining balances due to subsidiaries and associates are non-interest bearing and have not been discounted as they do not have any fixed repayment terms and the amount is not material.

## 37 Deferred income

The Group and The Company

| | **At 31 December** | | | **At 30 June** | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Deferred income on property development (note 18B) | 1,562 | 3,458 | 4,506 | 1,108 | 2,457 |
| Deferred income on lease out and lease back transaction (note 16G) | 126 | 132 | 137 | 120 | 126 |
| Less: Amount recognised as income | 6 | 6 | 5 | 2 | 3 |
| | 120 | 126 | 132 | 118 | 123 |
| | 1,682 | 3,584 | 4,638 | 1,226 | 2,580 |

## 38 Income tax in the balance sheet

*A* Current taxation in the consolidated balance sheet comprised overseas tax liabilities in respect of consultancy services income earned offshore, chargeable at the appropriate current tax rates of taxation ruling in the relevant countries.

***B Deferred tax assets and liabilities recognised***

The components of deferred tax assets and liabilities recognised in the balance sheet and the movements during the year/period are as follows:

The Group

| | Deferred tax arising from | | | | | |
|---|---|---|---|---|---|---|
| *in HK$ million* | **Depreciation allowances in excess of related depreciation** | **Revaluation of properties** | **Provision and other temporary differences** | **Cash flow hedges** | **Tax losses** | **Total** |
| **31 December 2006** | | | | | | |
| At 1 January 2006 | 8,895 | 2,242 | 228 | 5 | (3,378) | 7,992 |
| Charged/(credited) to consolidated profit and loss account | (146) | 381 | (23) | — | 1,197 | 1,409 |
| Charged to reserves (note 40) | — | 58 | — | (7) | — | 51 |
| At 31 December 2006 | 8,749 | 2,681 | 205 | (2) | (2,181) | 9,452 |
| **31 December 2005** | | | | | | |
| At 1 January 2005 | 8,663 | 1,666 | 229 | — | (4,205) | 6,353 |
| Charged/(credited) to consolidated profit and loss account | 232 | 490 | (1) | — | 827 | 1,548 |
| Charged to reserves (note 40) | — | 86 | — | 5 | — | 91 |
| At 31 December 2005 | 8,895 | 2,242 | 228 | 5 | (3,378) | 7,992 |
| **31 December 2004** | | | | | | |
| At 1 January 2004 | 8,393 | 1,173 | 249 | — | (4,646) | 5,169 |
| Charged/(credited) to consolidated profit and loss account | 270 | 435 | (20) | — | 441 | 1,126 |
| Charged to reserves (note 40) | — | 58 | — | — | — | 58 |
| At 31 December 2004 | 8,663 | 1,666 | 229 | — | (4,205) | 6,353 |
| **30 June 2007 (unaudited)** | | | | | | |
| At 1 January 2007 | 8,749 | 2,681 | 205 | (2) | (2,181) | 9,452 |
| Charged/(credited) to consolidated profit and loss account | 29 | 429 | (2) | — | 423 | 879 |
| Charged to reserves (note 40) | — | 25 | — | 17 | — | 42 |
| At 30 June 2007 | 8,778 | 3,135 | 203 | 15 | (1,758) | 10,373 |
| **30 June 2006 (unaudited)** | | | | | | |
| At 1 January 2006 | 8,895 | 2,242 | 228 | 5 | (3,378) | 7,992 |
| Charged/(credited) to consolidated profit and loss account | (241) | 259 | (40) | — | 1,005 | 983 |
| Charged to reserves (note 40) | — | 51 | — | (1) | — | 50 |
| At 30 June 2006 | 8,654 | 2,552 | 188 | 4 | (2,373) | 9,025 |

The Company

| *in HK$ million* | Deferred tax arising from: Depreciation allowances in excess of related depreciation | Revaluation of properties | Provision and other temporary differences | Cash flow hedges | Tax losses | Total |
|---|---|---|---|---|---|---|
| **31 December 2006** | | | | | | |
| At 1 January 2006 | 8,896 | 2,242 | 228 | 5 | (3,360) | 8,011 |
| Charged/(credited) to profit and loss account | (153) | 381 | (23) | — | 1,186 | 1,391 |
| Charged to reserves (note 40) | — | 58 | — | (7) | — | 51 |
| At 31 December 2006 | 8,743 | 2,681 | 205 | (2) | (2,174) | 9,453 |
| **31 December 2005** | | | | | | |
| At 1 January 2005 | 8,652 | 1,666 | 229 | — | (4,179) | 6,368 |
| Charged/(credited) to profit and loss account | 244 | 490 | (1) | — | 819 | 1,552 |
| Charged to reserves (note 40) | — | 86 | — | 5 | — | 91 |
| At 31 December 2005 | 8,896 | 2,242 | 228 | 5 | (3,360) | 8,011 |
| **31 December 2004** | | | | | | |
| At 1 January 2004 | 8,393 | 1,173 | 249 | — | (4,646) | 5,169 |
| Charged/(credited) to profit and loss account | 259 | 435 | (20) | — | 467 | 1,141 |
| Charged to reserves (note 40) | — | 58 | — | — | — | 58 |
| At 31 December 2004 | 8,652 | 1,666 | 229 | — | (4,179) | 6,368 |
| **30 June 2007 (unaudited)** | | | | | | |
| At 1 January 2007 | 8,743 | 2,681 | 205 | (2) | (2,174) | 9,453 |
| Charged/(credited) to profit and loss account | 29 | 429 | (2) | — | 423 | 879 |
| Charged to reserves (note 40) | — | 25 | — | 17 | — | 42 |
| At 30 June 2007 | 8,772 | 3,135 | 203 | 15 | (1,751) | 10,374 |
| **30 June 2006 (unaudited)** | | | | | | |
| At 1 January 2006 | 8,896 | 2,242 | 228 | 5 | (3,360) | 8,011 |
| Charged/(credited) to profit and loss account | (242) | 259 | (41) | — | 1,007 | 983 |
| Charged to reserves (note 40) | — | 51 | — | (1) | — | 50 |
| At 30 June 2006 | 8,654 | 2,552 | 187 | 4 | (2,353) | 9,044 |

Deferred tax assets and liabilities recognised in the balance sheet comprise:

The Group

| *in HK$ million* | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 *(unaudited)* | At 30 June 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Net deferred tax asset recognised | (1) | (19) | (15) | (1) | (19) |
| Net deferred tax liability recognised | 9,453 | 8,011 | 6,368 | 10,374 | 9,044 |
| | 9,452 | 7,992 | 6,353 | 10,373 | 9,025 |

The Company

| *in HK$ million* | At 31 December 2006 | At 31 December 2005 | At 31 December 2004 | At 30 June 2007 *(unaudited)* | At 30 June 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Net deferred tax liability recognised | 9,453 | 8,011 | 6,368 | 10,374 | 9,044 |
| | 9,453 | 8,011 | 6,368 | 10,374 | 9,044 |

***C*** The Group has not recognised deferred tax assets in respect of its subsidiaries' cumulative tax losses of HK$160 million (2006: HK$155 million; 2005: HK$77 million; 2004: HK$24 million) as it is not probable that future taxable profits against which the losses can be utilised will be available in the relevant tax jurisdictions and entities.

## 39 Share capital and capital management

### A *Share capital, share premium and capital reserve*

| *in HK$ million* | At 31 December 2006 | 2005 | 2004 |
|---|---|---|---|
| Authorised: | | | |
| 6,500,000,000 shares of HK$1.00 each | 6,500 | 6,500 | 6,500 |
| Issued and fully paid: | | | |
| 5,548,613,951 shares (2005: 5,481,856,439 shares; 2004: 5,389,999,974 shares) of HK$1.00 each | 5,549 | 5,482 | 5,390 |
| Share premium | 5,902 | 4,780 | 3,691 |
| Capital reserve | 27,188 | 27,188 | 27,188 |
| | 38,639 | 37,450 | 36,269 |

| *in HK$ million* | At 30 June 2007 *(unaudited)* | 2006 *(unaudited)* |
|---|---|---|
| Authorised: | | |
| 6,500,000,000 shares of HK$1.00 each | 6,500 | 6,500 |
| Issued and fully paid: | | |
| 5,588,539,505 shares (2006: 5,528,610,326 shares) of HK$1.00 each | 5,589 | 5,529 |
| Share premium | 6,644 | 5,531 |
| Capital reserve | 27,188 | 27,188 |
| | 39,421 | 38,248 |

Pursuant to the Articles of Association of the Company, the capital reserve can only be applied in paying up in full unissued shares to be allotted and distributed as fully paid bonus shares to the shareholders of the Company.

Share premium represents the amount by which the issue price of shares exceeds the par value of those shares. The application of the share premium account is governed by section 48B of the Hong Kong Companies Ordinance.

New shares issued and fully paid up during the period comprise:

| | Number of shares | Option/ scrip price | Proceeds credited to Share capital account | Proceeds credited to Share premium account | Total |
|---|---|---|---|---|---|
| | | *HK$* | *HK$ million* | *HK$ million* | *HK$ million* |
| Employee share options exercised | | | | | |
| — Pre-Global Offering Share Option Scheme | 711,000 | 8.44 | 1 | 5 | 6 |
| — New Joiners Share Option Scheme | 31,000 | 9.75 | — | — | — |
| Issued as 2006 final scrip dividends | 39,183,554 | 19.80 | 39 | 737 | 776 |
| | 39,925,554 | | 40 | 742 | 782 |

Outstanding share options under the Pre-Global Offering Share Option Scheme and New Joiners Share Option Scheme as at 30 June 2007 are disclosed in note 41.

***B Capital management***

The Group's primary objectives in managing capital are to safeguard its ability to continue as a going concern, and to generate sufficient profit to maintain growth and provide an adequate return to its shareholders.

The Group manages the amount of capital in proportion to risk, and makes adjustments to its capital structure through the amount of dividend payment to shareholders, issuance of scrip and new shares, and managing its debt portfolio in conjunction with projected financing requirement. The Financial Secretary Incorporated of the Hong Kong Government is the only major shareholder of the Company holding 4,285 million shares as of 30 June 2007, representing 76.7% of total equity interest in the Company.

The Group monitors capital on the basis of the debt to equity ratio, which is calculated on total borrowings as a percentage of the total equity attributable to shareholders of the Company where total borrowings are represented by the aggregate of loans, obligations under finance leases and bank overdrafts. The Group's debt to equity ratios over the past 5 years between 2002 and 2006 have been trending downward from nearly 60% towards 30% and it stood at 31.4% as of 30 June 2007.

## 40 Other reserves

The Group

| | **Attributable to equity shareholders of the Company** | | | | | |
|---|---|---|---|---|---|---|
| *in HK$ million* | **Fixed asset revaluation reserve** | **Hedging reserve** | **Employee share-based capital reserve** | **Exchange reserve** | **Retained profits** | **Total** |
| **31 December 2006** | | | | | | |
| Balance as at 1 January 2006 | 697 | 24 | 2 | 4 | 31,698 | 32,425 |
| Cash flow hedges: | | | | | | |
| Effective portion of changes in fair value, net of deferred tax | — | (18) | — | — | — | (18) |
| Transfer from equity | | | | | | |
| — to profit and loss account | — | (17) | — | — | — | (17) |
| — to initial carrying amount of non-financial hedged items | — | (2) | — | — | — | (2) |
| — to deferred tax | — | 3 | — | — | — | 3 |
| 2005 final dividend | — | — | — | — | (1,535) | (1,535) |
| 2006 interim dividend | — | — | — | — | (774) | (774) |
| Surplus on revaluation, net of deferred tax (notes 16 and 38) | 271 | — | — | — | — | 271 |
| Employee share-based payments | — | — | 3 | — | — | 3 |
| Exchange difference on translation of accounts of overseas subsidiaries | — | — | — | 13 | — | 13 |
| Profit for the year | — | — | — | — | 7,759 | 7,759 |
| Balance as at 31 December 2006 | 968 | (10) | 5 | 17 | 37,148 | 38,128 |

The Group

| *in HK$ million* | Attributable to equity shareholders of the Company<br>Fixed asset revaluation reserve | Hedging reserve | Employee share-based capital reserve | Exchange reserve | Retained profits | Total |
|---|---|---|---|---|---|---|
| **31 December 2005** | | | | | | |
| Balance as at 1 January 2005, as previously reported | 291 | — | 1 | — | 25,331 | 25,623 |
| Effect of prospective adoption of new accounting policy with respect to financial instruments | — | (66) | — | — | 190 | 124 |
| Balance as at 1 January 2005 | 291 | (66) | 1 | — | 25,521 | 25,747 |
| Cash flow hedges: | | | | | | |
| Effective portion of changes in fair value, net of deferred tax | — | 69 | — | — | — | 69 |
| Transfer from equity | | | | | | |
| — to profit and loss account | — | 32 | — | — | — | 32 |
| — to initial carrying amount of non-financial hedged items | — | (21) | — | — | — | (21) |
| — to deferred tax | — | 10 | — | — | — | 10 |
| 2004 final dividend | — | — | — | — | (1,509) | (1,509) |
| 2005 interim dividend | — | — | — | — | (764) | (764) |
| Surplus on revaluation, net of deferred tax (notes 16 and 38) | 406 | — | — | — | — | 406 |
| Employee share-based payments | — | — | 1 | — | — | 1 |
| Exchange difference on translation of accounts of overseas subsidiaries | — | — | — | 4 | — | 4 |
| Profit for the year | — | — | — | — | 8,450 | 8,450 |
| Balance as at 31 December 2005 | 697 | 24 | 2 | 4 | 31,698 | 32,425 |
| **31 December 2004** | | | | | | |
| Balance as at 1 January 2004 | 18 | — | — | — | 21,019 | 21,037 |
| 2003 final dividend | — | — | — | — | (1,481) | (1,481) |
| 2004 interim dividend | — | — | — | — | (750) | (750) |
| Surplus on revaluation, net of deferred tax (notes 16 and 38) | 273 | — | — | — | — | 273 |
| Employee share-based payments | — | — | 1 | — | — | 1 |
| Profit for the year | — | — | — | — | 6,543 | 6,543 |
| Balance as at 31 December 2004 | 291 | — | 1 | — | 25,331 | 25,623 |

The Group

| *in HK$ million* | Fixed asset revaluation reserve | Hedging reserve | Employee share-based capital reserve | Exchange reserve | Retained profits | Total |
|---|---|---|---|---|---|---|
| | **Attributable to equity shareholders of the Company** | | | | | |
| **30 June 2007 (unaudited)** | | | | | | |
| Balance as at 1 January 2007 | 968 | (10) | 5 | 17 | 37,148 | 38,128 |
| Cash flow hedges: | | | | | | |
| Effective portion of changes in fair value, net of deferred tax | — | 81 | — | — | — | 81 |
| Transfer from equity | | | | | | |
| — to profit and loss account | — | — | — | — | — | — |
| — to initial carrying amount of non-financial hedged items | — | — | — | — | — | — |
| — to deferred tax | — | — | — | — | — | — |
| 2006 final dividend | — | — | — | — | (1,554) | (1,554) |
| Surplus on revaluation, net of deferred tax (notes 16 and 38) | 120 | — | — | — | — | 120 |
| Employee share-based payments | — | — | — | — | — | — |
| Exchange difference on translation of accounts of overseas subsidiaries | — | — | — | 10 | — | 10 |
| Profit for the period | — | — | — | — | 4,071 | 4,071 |
| Balance as at 30 June 2007 | 1,088 | 71 | 5 | 27 | 39,665 | 40,856 |
| **30 June 2006 (unaudited)** | | | | | | |
| Balance as at 1 January 2006 | 697 | 24 | 2 | 4 | 31,698 | 32,425 |
| Cash flow hedges: | | | | | | |
| Effective portion of changes in fair value, net of deferred tax | — | 6 | — | — | — | 6 |
| Transfer from equity | | | | | | |
| — to profit and loss account | — | (11) | — | — | — | (11) |
| — to initial carrying amount of non-financial hedged items | — | (2) | — | — | — | (2) |
| — to deferred tax | — | 2 | — | — | — | 2 |
| 2005 final dividend | — | — | — | — | (1,535) | (1,535) |
| Surplus on revaluation, net of deferred tax (notes 16 and 38) | 242 | — | — | — | — | 242 |
| Employee share-based payments | — | — | 2 | — | — | 2 |
| Exchange difference on translation of accounts of overseas subsidiaries | — | — | — | 3 | — | 3 |
| Profit for the period | — | — | — | — | 5,167 | 5,167 |
| Balance as at 30 June 2006 | 939 | 19 | 4 | 7 | 35,330 | 36,299 |

The Company

| *in HK$ million* | Fixed asset revaluation reserve | Hedging reserve | Employee share-based capital reserve | Retained profits | Total |
|---|---|---|---|---|---|
| **31 December 2006** | | | | | |
| Balance as at 1 January 2006 | 697 | 24 | 2 | 31,394 | 32,117 |
| Cash flow hedges: | | | | | |
| Effective portion of changes in fair value, net of deferred tax | — | (18) | — | — | (18) |
| Transfer from equity | | | | | |
| — to profit and loss account | — | (17) | — | — | (17) |
| — to initial carrying amount of non-financial hedged items | — | (2) | — | — | (2) |
| — to deferred tax | — | 3 | — | — | 3 |
| 2005 final dividend | — | — | — | (1,535) | (1,535) |
| 2006 interim dividend | — | — | — | (774) | (774) |
| Surplus on revaluation, net of deferred tax (notes 16 and 38) | 271 | — | — | — | 271 |
| Employee share-based payments | — | — | 3 | — | 3 |
| Profit for the year | — | — | — | 7,717 | 7,717 |
| Balance as at 31 December 2006 | 968 | (10) | 5 | 36,802 | 37,765 |
| **31 December 2005** | | | | | |
| Balance as at 1 January 2005, as previously reported | 291 | — | 1 | 25,113 | 25,405 |
| Effect of prospective adoption of new accounting policy with respect to financial instruments | — | (66) | — | 190 | 124 |
| Balance as at 1 January 2005 | 291 | (66) | 1 | 25,303 | 25,529 |
| Cash flow hedges: | | | | | |
| Effective portion of changes in fair value, net of deferred tax | — | 69 | — | — | 69 |
| Transfer from equity | | | | | |
| — to profit and loss account | — | 32 | — | — | 32 |
| — to initial carrying amount of non-financial hedged items | — | (21) | — | — | (21) |
| — to deferred tax | — | 10 | — | — | 10 |
| 2004 final dividend | — | — | — | (1,509) | (1,509) |
| 2005 interim dividend | — | — | — | (764) | (764) |
| Surplus on revaluation, net of deferred tax (notes 16 and 38) | 406 | — | — | — | 406 |
| Employee share-based payments | — | — | 1 | — | 1 |
| Profit for the year | — | — | — | 8,364 | 8,364 |
| Balance as at 31 December 2005 | 697 | 24 | 2 | 31,394 | 32,117 |

The Company

| *in HK$ million* | **Fixed asset revaluation reserve** | **Hedging reserve** | **Employee share-based capital reserve** | **Retained profits** | **Total** |
|---|---|---|---|---|---|
| **31 December 2004** | | | | | |
| Balance as at 1 January 2004 | 18 | — | — | 20,818 | 20,836 |
| 2003 final dividend | — | — | — | (1,481) | (1,481) |
| 2004 interim dividend | — | — | — | (750) | (750) |
| Surplus on revaluation, net of deferred tax (notes 16 and 38) | 273 | — | — | — | 273 |
| Employee share-based payments | — | — | 1 | — | 1 |
| Profit for the year | — | — | — | 6,526 | 6,526 |
| Balance as at 31 December 2004 | 291 | — | 1 | 25,113 | 25,405 |
| **30 June 2007 (unaudited)** | | | | | |
| Balance as at 1 January 2007 | 968 | (10) | 5 | 36,802 | 37,765 |
| Cash flow hedges: | | | | | |
| Effective portion of changes in fair value, net of deferred tax | — | 81 | — | — | 81 |
| Transfer from equity | | | | | |
| — to profit and loss account | — | — | — | — | — |
| — to initial carrying amount of non-financial hedged items | — | — | — | — | — |
| — to deferred tax | — | — | — | — | — |
| 2006 final dividend | — | — | — | (1,554) | (1,554) |
| Surplus on revaluation, net of deferred tax (notes 16 and 38) | 120 | — | — | — | 120 |
| Employee share-based payments | — | — | — | — | — |
| Profit for the period | — | — | — | 4,000 | 4,000 |
| Balance as at 30 June 2007 | 1,088 | 71 | 5 | 39,248 | 40,412 |
| **30 June 2006 (unaudited)** | | | | | |
| Balance as at 1 January 2006 | 697 | 24 | 2 | 31,394 | 32,117 |
| Cash flow hedges: | | | | | |
| Effective portion of changes in fair value, net of deferred tax | — | 6 | — | — | 6 |
| Transfer from equity | | | | | |
| — to profit and loss account | — | (11) | — | — | (11) |
| — to initial carrying amount of non-financial hedged items | — | (2) | — | — | (2) |
| — to deferred tax | — | 2 | — | — | 2 |
| 2005 final dividend | — | — | — | (1,535) | (1,535) |
| Surplus on revaluation, net of deferred tax (notes 16 and 38) | 242 | — | — | — | 242 |
| Employee share-based payments | — | — | 2 | — | 2 |
| Profit for the period | — | — | — | 5,134 | 5,134 |
| Balance as at 30 June 2006 | 939 | 19 | 4 | 34,993 | 35,955 |

The fixed asset revaluation reserve was set up to deal with the surpluses or deficits arising from the revaluation of self-occupied land and buildings (note 2F(ii)).

The hedging reserve comprises the effective portion of the cumulative net change in the fair value of hedging instruments used in cash flow hedges pending subsequent recognition of the hedged cash flow in accordance with the accounting policy adopted for cash flow hedges in note 2T(ii).

The employee share-based capital reserve comprises the fair value of share options granted which are yet to be exercised, as explained in accounting policy under note 2U(iv). The amount will either be transferred to the share premium account when the option is exercised, or be released directly to retained profits if the option is expired or forfeited.

The exchange reserve comprises all foreign exchange differences arising from the translation of the accounts of foreign enterprises. The reserve is dealt with in accordance with the accounting policy set out in note 2CC.

Apart from retained profits, the other reserves are not available for distribution to shareholders because they do not constitute realised profits. In addition, the Company considers the cumulative surpluses on revaluation of investment properties, net of tax of HK$13,692 million (2006: HK$11,671 million; 2005: HK$9,874 million; 2004: HK$7,564 million) included in retained profits are non-distributable as they also do not constitute realised profits. As at 30 June 2007, the Company considered that the total amount of reserves available for distribution to equity shareholders amounted to HK$25,556 million (2006: HK$25,131 million; 2005: HK$21,520 million; 2004: HK$17,549 million).

Included in the Group's retained profits as at 30 June 2007 is an amount of HK$135 million (2006: HK$93 million; 2005: HK$48 million; 2004: HK$39 million), being the retained profits attributable to the non-controlled subsidiaries and associates.

## 41 Share-based payments

### *A Equity-settled share-based payments*

The Group granted equity-settled share options to its Members of the Executive Directorate (except C K Chow) and certain employees under two share option schemes, the Pre-Global Offering Share Option Scheme and New Joiners Share Option Scheme. In addition, the Group adopted the 2007 Share Option Scheme at the 2007 Annual General Meeting, but no options have been granted under this scheme as of 30 June 2007. Details of the schemes are as follows:

i *Pre-Global Offering Share Option Scheme*

In connection with the Initial Public Offering ("IPO") and Stock Exchange listing of the Company's shares in October 2000, a Pre-Global Offering Share Option Scheme ("Pre-IPO Option Scheme") was established. Under the Pre-IPO Option Scheme, a total of 769 employees including all the Members of the Executive Directorate, except C K Chow, Lincoln K K Leong and Francois K K Lung who were appointed on 1 December 2003, 1 February 2002 and 26 September 2005 respectively, were granted on 20 September 2000 options to purchase an aggregate of 48,338,000 shares, representing 0.9% of the issued share capital of the Company as at 30 June 2007. The options carry an exercise price of HK$8.44 per share, which was equivalent to 90% of the IPO offer price of HK$9.38 per share. The options may be exercised prior to 11 September 2010, subject to the vesting provisions under the Scheme. As of 30 June 2007, all options granted under the Pre-IPO Option Scheme have vested.

During the six months ended 30 June 2007, a total of 711,000 previously vested share options have been exercised. The weighted average closing price in respect of the share options exercised during the period was HK$20.11 per share. In addition, no share options lapsed as a result of the resignation of option holders during the period. As at 30 June 2007, total options to subscribe for 7,118,500 (2006: 7,829,500; 2005: 11,923,500; 2004: 17,206,000) shares remained outstanding.

As the options under Pre-IPO Option Scheme were granted before 7 November 2002, no share-based payment was required to be recognised in accordance with HKFRS 2 "Share-based payment".

ii *New Joiners Share Option Scheme*

In May 2002, the New Joiners Share Option Scheme (the "New Option Scheme") was adopted at the 2002 Annual General Meeting to provide share options to new members of the top and senior management of the Company who did not participate in the Pre-IPO Option Scheme. Under the Rules of the New Option Scheme, a maximum of 5,056,431 shares, which represent 0.1% of the issued share capital of the Company as at 30 June 2007, may be issued pursuant to the exercise of options granted under the New Option Scheme. Options granted will be evenly vested in respect of their underlying shares over a period of three years from the date on which the relevant option is offered. The exercise price of any option granted under the New Option Scheme is to be determined by the Company upon the offer of grant of the option and which should not be less than the greatest of (i) the average closing price of an MTR share for the five business days immediately preceding the day of offer of such option; (ii) the closing price of an MTR share on the day of offer of such option, which must be a business day; and (iii) the nominal value of an MTR share. The New Option Scheme expired on 16 May 2007 and no options could be granted under this Scheme on or after that date.

The following table summarises the outstanding share options granted under the New Option Scheme since inception:

| **Date of grant** | **Number of share options** | **Exercise price** *HK$* | **Exercisable period** |
|---|---:|---:|---:|
| 1 August 2003 | 1,311,200 | 9.75 | on or prior to 14 July 2013 |
| 13 September 2005 | 94,000 | 15.97 | on or prior to 9 September 2015 |
| 23 September 2005 | 213,000 | 15.97 | on or prior to 9 September 2015 |
| 12 January 2006 | 94,000 | 15.45 | on or prior to 9 January 2016 |
| 31 March 2006 | 94,000 | 18.05 | on or prior to 20 March 2016 |
| 12 May 2006 | 266,500 | 20.66 | on or prior to 25 April 2016 |
| 12 May 2006 | 213,000 | 21.00 | on or prior to 2 May 2016 |
| 15 May 2006 | 213,000 | 20.66 | on or prior to 25 April 2016 |
| 4 July 2006 | 94,000 | 18.30 | on or prior to 19 June 2016 |
| 5 October 2006 | 94,000 | 19.732 | on or prior to 29 September 2016 |
| 17 November 2006 | 94,000 | 19.104 | on or prior to 13 November 2016 |
| 22 March 2007 | 1,066,000 | 19.404 | on or prior to 19 March 2017 |

Movements in the number of share options outstanding and their related weighted average exercise prices were as follows:

| | At 31 December | | | | | |
|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2004 | |
| | Number of options | Weighted average exercise price *HK$* | Number of options | Weighted average exercise price *HK$* | Number of options | Weighted average exercise price *HK$* |
| Outstanding at 1 January | 2,910,700 | 12.81 | 1,561,200 | 9.75 | 1,561,200 | 9.75 |
| Granted during the year | 1,256,500 | 19.57 | 1,467,000 | 15.82 | — | — |
| Exercised during the year | (132,500) | 9.75 | (117,500) | 9.75 | — | — |
| Lapsed during the year | (1,254,000) | 15.94 | — | — | — | — |
| Outstanding at 31 December | 2,780,700 | 14.60 | 2,910,700 | 12.81 | 1,561,200 | 9.75 |
| Exercisable at 31 December | 1,413,700 | 10.20 | 924,500 | 9.75 | 521,000 | 9.75 |

| | At 30 June | | | |
|---|---|---|---|---|
| | 2007 *(unaudited)* | | 2006 *(unaudited)* | |
| | Number of options | Weighted average exercise price *HK$* | Number of options | Weighted average exercise price *HK$* |
| Outstanding at 1 January | 2,780,700 | 14.598 | 2,910,700 | 12.81 |
| Granted during the period | 1,066,000 | 19.404 | 974,500 | 19.73 |
| Exercised during the period | (31,000) | 9.750 | (101,500) | 9.75 |
| Lapsed during the period | — | — | (94,000) | 16.05 |
| Outstanding at 30 June | 3,815,700 | 15.980 | 3,689,700 | 14.64 |
| Exercisable at 30 June | 1,708,200 | 12.03 | 823,000 | 9.75 |

The weighted average closing price in respect of the share options exercised during the six months ended 30 June 2007 was HK$19.72 (2006: HK$20.43; 2005: HK$15.21; 2004: N/A).

Share options outstanding, their exercise prices and remaining contractual lives were as follows:

| | At 31 December | | | | | |
|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2004 | |
| **Exercise price** | **Number of options** | **Remaining contractual life** | **Number of options** | **Remaining contractual life** | **Number of options** | **Remaining contractual life** |
| | | *years* | | *years* | | *years* |
| HK$9.75 | 1,311,200 | 6.53 | 1,443,700 | 7.53 | 1,561,200 | 8.53 |
| HK$15.97 | 307,000 | 8.69 | 307,000 | 9.69 | — | — |
| HK$15.75 | — | — | 1,066,000 | 9.74 | — | — |
| HK$16.05 | — | — | 94,000 | 9.76 | — | — |
| HK$15.45 | 94,000 | 9.02 | — | — | — | — |
| HK$18.05 | 94,000 | 9.22 | — | — | — | — |
| HK$20.66 | 479,500 | 9.32 | — | — | — | — |
| HK$21.00 | 213,000 | 9.34 | — | — | — | — |
| HK$18.30 | 94,000 | 9.47 | — | — | — | — |
| HK$19.732 | 94,000 | 9.75 | — | — | — | — |
| HK$19.104 | 94,000 | 9.87 | — | — | — | — |
| | 2,780,700 | 7.96 | 2,910,700 | 8.64 | 1,561,200 | 8.53 |

| | At 30 June | | | |
|---|---|---|---|---|
| | 2007 *(unaudited)* | | 2006 *(unaudited)* | |
| **Exercise price** | **Number of options** | **Remaining contractual life** | **Number of options** | **Remaining contractual life** |
| | | *years* | | *years* |
| HK$9.75 | 1,280,200 | 6.03 | 1,342,200 | 7.03 |
| HK$15.97 | 307,000 | 8.19 | 307,000 | 9.19 |
| HK$15.75 | — | — | 1,066,000 | 9.24 |
| HK$15.45 | 94,000 | 8.52 | 94,000 | 9.52 |
| HK$18.05 | 94,000 | 8.72 | 188,000 | 9.72 |
| HK$20.66 | 479,500 | 8.82 | 479,500 | 9.82 |
| HK$21.00 | 213,000 | 8.84 | 213,000 | 9.84 |
| HK$18.30 | 94,000 | 8.97 | — | — |
| HK$19.732 | 94,000 | 9.25 | — | — |
| HK$19.104 | 94,000 | 9.37 | — | — |
| HK$19.404 | 1,066,000 | 9.72 | — | — |
| | 3,815,700 | 8.10 | 3,689,700 | 8.57 |

According to the Black-Scholes pricing model, the fair value of options granted during the six months ended 30 June 2007 was as follows:

| Date of grant | Fair value of options granted | Share price immediately before grant date | Exercise price | Expected volatility | Expected life | Risk-free interest rate | Expected dividend per share |
|---|---|---|---|---|---|---|---|
| | | | **Inputs into the Black-Scholes pricing model** | | | | |
| | *HK$* | *HK$* | *HK$* | | *years* | *%* | *HK$* |
| 22 March 2007 | 3.79 | 19.32 | 19.404 | 0.21 | 5 | 3.96 | 0.42 |

When computing fair values of the options granted, expected volatility was determined by calculating the historical volatility of the Group's share price over the previous 5 years and the expected life adopted was assumed to be the fifth year after granting of the options, with expected dividends based on historical dividends. In addition, vesting terms under the grants have been taken into account whilst no market conditions associated with the share option grants have been considered. Changes in the subjective input assumptions could materially affect the fair value estimate.

During the six months ended 30 June 2007, the Group recognised total expenses of HK$0.4 million (2006: HK$3 million; 2005: HK$1 million; 2004: HK$1 million) related to equity-settled share-based payments.

iii *2007 Share Option Scheme*

Since the New Option Scheme expired in May 2007, the 2007 Share Option Scheme (the "2007 Scheme") was submitted for approval and was adopted at the 2007 Annual General Meeting to enhance the Company's ability to attract the best available personnel, to retain and motivate critical and key employees, to align their interest to the long-term success of the Company and to provide them fair and market competitive remuneration. Under the Rules of the 2007 Scheme, a maximum of 277,461,072 shares, which represent 5% of the issued share capital of the Company as at 7 June 2007, may be issued pursuant to the exercise of options granted after 7 June 2007 under all share option schemes of the Company including the 2007 Scheme. Options granted will vest in respect of their underlying shares not less than 1 year from the date on which the relevant option is offered. The exercise price of any option granted under the 2007 Scheme is to be determined by the Company upon the offer of grant of the option and which should not be less than the greatest of (i) the average closing price of an MTR share for the five business days immediately preceding the day of offer of such option; (ii) the closing price of an MTR share on the day of offer of such option, which must be a business day; and (iii) the nominal value of an MTR share.

As of 30 June 2007, no options have been granted under the 2007 Scheme.

***B Cash-settled share-based payments***

i C K Chow did not participate in the Company's Pre-Global Offering Share Option Scheme and New Joiners Share Option Scheme. He was entitled to receive an equivalent value in cash of 700,000 shares on completion of his initial three-year contract on 30 November 2006. Pursuant to this contract and following the completion of the contract period, HK$13,396,600 was paid to C K Chow on 1 December 2006 (at a price of HK$19.138 per share derived in accordance with the terms of the grant by reference to the average closing price of the Company's shares on the 20 business days immediately preceding 30 November 2006).

Following renewal of C K Chow's contract for another three years expiring on 30 November 2009, he is entitled to receive an equivalent value in cash of 418,017 shares in the Company on completion of his new contract in 2009. As at 30 June 2007, an amount of HK$1.3 million (2006: HK$6.2 million; 2005: HK$4.3 million; 2004: HK$2.9 million) has been recorded as share-based payment expense for the six months ended on the same date. Fair value of the outstanding entitlement is calculated based on the closing price of the Company's shares at period-end date. As at 30 June 2007, the fair value of these shares was HK$18.52 per share (2006: HK$19.56; 2005: HK$15.25; 2004: HK$12.45).

ii Lincoln K K Leong has a derivative interest in the Company's shares, which entitled him to receive an equivalent value in cash of 160,000 shares in the Company on 9 April 2010. As at 30 June 2007, an amount of HK$0.2 million (2006: nil; 2005: nil; 2004: nil) has been recorded as share-based payment expense for the six months ended on the same date, measured at the same basis as described in note 41B(i) above.

## 42 Retirement Schemes

The Company operates two occupational retirement schemes, the MTR Corporation Limited Retirement Scheme (the "Retirement Scheme") and a top-up scheme, the MTR Corporation Limited Retention Bonus Scheme (the "RBS"). In addition, in accordance with the Mandatory Provident Fund ("MPF") Schemes Ordinance, the Company has set up an MPF Scheme on 1 December 2000 by participating in a master trust scheme provided by an independent MPF service provider. Employees eligible to join the Retirement Scheme can choose between the Retirement Scheme and the MPF Scheme while temporary employees are required to join the MPF Scheme.

The assets of these schemes are held under the terms of separate trust arrangements so that the assets are kept separate from those of the Company.

### *A Retirement Scheme*

The Retirement Scheme was established under trust at the beginning of 1977. The Retirement Scheme contains both defined benefit and defined contribution elements. The Retirement Scheme was registered under the Occupational Retirement Schemes Ordinance (Chapter 426 of the Laws of Hong Kong) ("ORSO") with effect from 31 October 1994. On 3 July 2000, exemption was granted by the MPF Authority to maintain the Retirement Scheme and offer it as an alternative to the MPF Scheme.

The Retirement Scheme provides both a hybrid benefit section and a defined contribution benefit section, offering benefits on retirement, permanent disability, death and leaving service to its members. The hybrid benefit section provides benefits based on the greater of a multiple of final salary and accumulated contributions with investment returns. The defined contribution benefit section, which was implemented on 1 April 1999, is a member choice plan which provides retirement benefits based on accumulated contributions and investment returns only. Promotees who are promoted after 1 April 1999 can choose to join either the defined contribution benefit section or to remain in the hybrid benefit section. As the hybrid benefit section was closed to new entrants on 31 March 1999, staff joining the Company on or after 1 April 1999 who would be eligible to join the Retirement Scheme can choose to join either the defined contribution benefit section or, commencing 1 December 2000, the MPF Scheme.

i *The hybrid benefit section*

Members' contributions to the hybrid benefit section are based on a fixed percentage of basic salary. The Company's contributions are determined by the Executive Directorate with reference to an actuarial valuation. At 30 June 2007, the total membership was 5,702 (2006: 5,749; 2005: 5,844; 2004: 5,966). During the six months ended 30 June 2007, members contributed HK$29 million (2006: HK$65 million; 2005: HK$65 million; 2004: HK$67 million) and the Company contributed HK$70 million (2006: HK$166 million; 2005: HK$165 million; 2004: HK$224 million) to the hybrid benefit section. The net asset value of the hybrid benefit section as at 30 June 2007 was HK$7,391 million (2006: HK$6,906 million; 2005: HK$5,899 million; 2004: HK$5,365 million).

ii *The defined contribution benefit section*

Both members' and the Company's contributions to the defined contribution benefit section are based on fixed percentages of members' basic salary. As at 30 June 2007, the total membership under this section was 581 (2006: 599; 2005: 501; 2004: 406). During the six months ended 30 June 2007, total members' contributions were HK$5.0 million (2006: HK$9.9 million; 2005: HK$5.5 million; 2004: HK$6.4 million) and the total contribution from the Company was HK$9.9 million (2006: HK$20.3 million; 2005: HK$9.6 million; 2004: HK$13.3 million). The net asset value as at 30 June 2007 was HK$166.3 million (2006: HK$141.7 million; 2005: HK$97.7 million; 2004: HK$74.8 million).

According to the terms of the trust deed, forfeitures were transferred to the reserve account to be utilised at the discretion of the Company.

iii *Actuarial valuations*

Actuarial valuations are carried out annually in accordance with the ORSO. A full actuarial valuation of the Retirement Scheme, comprising both the hybrid and the defined contribution benefit sections, was carried out at 31 December 2006 by Towers, Perrin, Forster & Crosby, Inc., an independent firm of consulting actuaries, using the Attained Age Method. The principal actuarial assumptions used included a long-term rate of investment return net of salary increases of 2.0% (2005: 2.0%; 2004: 2.0%) per annum, together with appropriate allowances for expected rates of mortality, turnover, redundancy and retirement and an adjustment for salary increases expected over the short term. The actuary confirmed that, at the valuation date:

(a) the Scheme was solvent, with assets more than adequate to cover the aggregate value of members' vested benefits had all members left the Scheme; and

(b) the value of the Scheme's assets was more than sufficient to cover the aggregate past service liability on the assumption that the Scheme continued in force. The corresponding funding level was 116%.

***B RBS***

The RBS was established under trust as of 1 January 1995. The RBS is a defined benefit scheme and applies to all employees classified by the Company as staff working on designated projects and who are not on gratuity terms. The RBS provides for benefits to be payable only in the event of redundancy for accrued service up to 31 December 2002. The RBS was registered under the Occupational Retirement Schemes Ordinance with effect from 1 December 1995. As at 30 June 2007, there were 358 members (2006: 358; 2005: 366; 2004: 397) under the RBS.

The RBS is non-contributory for members. The Company's contributions are determined by the Executive Directorate with reference to an actuarial valuation and are charged as part of the staff costs to various projects on the basis of the amount contributed. During the years ended 31 December 2005 and 2006, and six months ended 30 June 2006 and 2007, the Company was not required to make any contributions to the Scheme (2004: HK$2 million). The net asset value of the RBS as at 30 June 2007 was HK$12 million (2006: HK$12 million; 2005: HK$13 million; 2004: HK$14 million).

Actuarial valuations are carried out annually. A full actuarial valuation of the RBS was carried out at 31 December 2006 by Towers, Perrin, Forster & Crosby, Inc. using the Attained Age Method. The principal actuarial assumptions used included an expected weighted rate of investment return net of salary increases, of approximately -1.25% (2005: -1.35%; 2004: -1.25%) per annum, together with appropriate allowance for expected rates of redundancy. The actuary confirmed that, at the valuation date:

(a) due to the nature of the RBS which provides for benefits only on redundancy, there was no aggregate vested liability, and thus the RBS was technically solvent; and

(b) the value of the RBS assets, together with the future contributions recommended by the actuary and to be adopted by the Company, would be sufficient to meet the liabilities of the RBS on an on-going basis.

***C MPF Scheme***

Effective from the MPF commencement date of 1 December 2000, the Company joined The Bank Consortium MPF Plan which has been registered with the Mandatory Provident Fund Schemes Authority and authorised by the Securities and Futures Commission. As at 30 June 2007, the total number of employees of the Company participating in the MPF Scheme was 811 (2006: 726; 2005: 520; 2004: 478). During the six months ended 30 June 2007, total members' contributions were HK$1.7 million (2006: HK$2.7 million; 2005: HK$1.5 million; 2004: HK$1.6 million) and total contribution from the Company was HK$2.0 million (2006: HK$3.0 million; 2005: HK$1.9 million; 2004: HK$2.5 million).

## 43 Defined benefit retirement plan obligations

The Group makes contributions to two defined benefit plans that provide benefits for employees upon retirement or termination of services for other reasons (note 42). Actuarial valuation is conducted annually at 31 December each year to ascertain the financial portion of these plans in accordance with the requirements of HKAS 19, "Employee benefits". The movements in respect of these defined benefit plans during the years 2004, 2005 and 2006 are summarised as follows.

***A*** The amounts recognised in the balance sheets are as follows:

The Group and The Company

| | At 31 December | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2006 | | | 2005 | | | 2004 | | |
| *in HK$ million* | **Retirement Scheme** | **RBS** | **Total** | **Retirement Scheme** | **RBS** | **Total** | **Retirement Scheme** | **RBS** | **Total** |
| Present value of funded obligations | 7,311 | 3 | 7,314 | 5,974 | 7 | 5,981 | 5,456 | 7 | 5,463 |
| Fair value of plan assets | (6,906) | (12) | (6,918) | (5,899) | (13) | (5,912) | (5,365) | (14) | (5,379) |
| Net unrecognised actuarial gains/(losses) | (520) | 5 | (515) | (172) | 2 | (170) | (188) | 6 | (182) |
| Net asset | (115) | (4) | (119) | (97) | (4) | (101) | (97) | (1) | (98) |

A portion of the above asset is expected to be recovered after more than one year. However, it is not practicable to segregate this amount from the amounts receivable in the next twelve months, as future contributions will also relate to future services rendered and future changes in actuarial assumptions and market conditions. The Group expects to pay HK$151 million in contribution to the Retirement Scheme in 2007.

***B*** Plan assets consist of the following:

The Group and The Company

| | At 31 December | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2006 | | | 2005 | | | 2004 | | |
| *in HK$ million* | **Retirement Scheme** | **RBS** | **Total** | **Retirement Scheme** | **RBS** | **Total** | **Retirement Scheme** | **RBS** | **Total** |
| Equity securities | 3,623 | — | 3,623 | 3,245 | — | 3,245 | 2,883 | — | 2,883 |
| Bonds | 3,128 | — | 3,128 | 2,531 | — | 2,531 | 2,406 | — | 2,406 |
| Cash | 198 | 12 | 210 | 158 | 13 | 171 | 106 | 14 | 120 |
| | 6,949 | 12 | 6,961 | 5,934 | 13 | 5,947 | 5,395 | 14 | 5,409 |
| Voluntary units | (43) | — | (43) | (35) | — | (35) | (30) | — | (30) |
| | 6,906 | 12 | 6,918 | 5,899 | 13 | 5,912 | 5,365 | 14 | 5,379 |

Included in the plan assets are investments in the Company's ordinary shares and debt securities of HK$1 million (2005: HK$1 million; 2004: nil) and HK$13 million (2005: HK$10 million; 2004: nil) respectively.

*C* ***Movements in the present value of the defined benefit obligations***

The Group and The Company

| | 31 December | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2006 | | | 2005 | | | 2004 | | |
| *in HK$ million* | **Retirement Scheme** | **RBS** | **Total** | **Retirement Scheme** | **RBS** | **Total** | **Retirement Scheme** | **RBS** | **Total** |
| At 1 January | 5,974 | 7 | 5,981 | 5,456 | 7 | 5,463 | 4,276 | 14 | 4,290 |
| Members' contributions paid to the Schemes | 65 | — | 65 | 65 | — | 65 | 67 | — | 67 |
| Benefits paid by the Schemes | (91) | (1) | (92) | (141) | (1) | (142) | (90) | (2) | (92) |
| Current service cost | 253 | — | 253 | 261 | — | 261 | 228 | — | 228 |
| Interest cost | 251 | — | 251 | 230 | — | 230 | 222 | 1 | 223 |
| Actuarial (gains)/losses | 859 | (3) | 856 | 103 | 1 | 104 | 753 | (6) | 747 |
| At 31 December | 7,311 | 3 | 7,314 | 5,974 | 7 | 5,981 | 5,456 | 7 | 5,463 |

*D* ***Movements in plan assets***

The Group and The Company

| | 31 December | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2006 | | | 2005 | | | 2004 | | |
| *in HK$ million* | **Retirement Scheme** | **RBS** | **Total** | **Retirement Scheme** | **RBS** | **Total** | **Retirement Scheme** | **RBS** | **Total** |
| At 1 January | 5,899 | 13 | 5,912 | 5,365 | 14 | 5,379 | 4,638 | 14 | 4,652 |
| Group's contributions paid to the Schemes | 166 | — | 166 | 165 | — | 165 | 224 | 2 | 226 |
| Members' contributions paid to the Schemes | 65 | — | 65 | 65 | — | 65 | 67 | — | 67 |
| Benefits paid by the Schemes | (91) | (1) | (92) | (141) | (1) | (142) | (90) | (2) | (92) |
| Expected return on plan assets | 357 | — | 357 | 326 | — | 326 | 284 | 1 | 285 |
| Actuarial gains/(losses) | 510 | — | 510 | 119 | — | 119 | 242 | (1) | 241 |
| At 31 December | 6,906 | 12 | 6,918 | 5,899 | 13 | 5,912 | 5,365 | 14 | 5,379 |

*E* Expense recognised in the consolidated profit and loss account is as follows:

| | Year ended 31 December | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2006 | | | 2005 | | | 2004 | | |
| *in HK$ million* | Retirement Scheme | RBS | Total | Retirement Scheme | RBS | Total | Retirement Scheme | RBS | Total |
| Current service cost | 253 | — | 253 | 261 | — | 261 | 228 | — | 228 |
| Interest cost | 251 | — | 251 | 230 | — | 230 | 222 | 1 | 223 |
| Expected return on plan assets | (357) | — | (357) | (326) | — | (326) | (284) | (1) | (285) |
| Net actuarial (gain)/loss recognised | — | (1) | (1) | — | (3) | (3) | — | (1) | (1) |
| Expense recognised | 147 | (1) | 146 | 165 | (3) | 162 | 166 | (1) | 165 |
| Less: Amount capitalised | 24 | (1) | 23 | 31 | (3) | 28 | 28 | (1) | 27 |
| | 123 | — | 123 | 134 | — | 134 | 138 | — | 138 |

The retirement expense is recognised under staff costs and related expenses in the consolidated profit and loss account.

*F* ***Actual return on plan assets***

| | Year ended 31 December | | |
|---|---|---|---|
| *in HK$ million* | 2006 | 2005 | 2004 |
| MTRCL Retirement Scheme | 867 | 445 | 526 |
| MTRCL Retention Bonus Scheme | — | — | — |

*G* The principal actuarial assumptions used as at 31 December 2006, 2005 and 2004 (expensed as weighted average) are as follows:

| | At 31 December | | | | | |
|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2004 | |
| | Retirement Scheme | RBS | Retirement Scheme | RBS | Retirement Scheme | RBS |
| Discount rate at 31 December | 3.75% | 3.50% | 4.25% | 4.00% | 4.25% | 1.00% |
| Expected rate of return on plan assets | 6.00% | 2.75% | 6.00% | 2.25% | 6.00% | 1.50% |
| Future salary increases | 4.00% | 4.00% | 4.00% | 3.60% | 4.00% | 2.75% |

The expected long-term rate of return on plan assets have been determined after taking into account actual experience, expected investment volatility and inflation in the long-term. Furthermore, it is based on the portfolio as a whole and not on the sum of the returns on individual asset categories. The amount is based exclusively on historical returns, without adjustments.

***H Historical information***

The Group and The Company

| *in HK$ million* | Retirement Scheme 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|
| Present value of funded obligations | 7,311 | 5,974 | 5,456 | 4,277 | 3,775 |
| Fair value of plan assets | 6,906 | 5,899 | 5,365 | 4,638 | 3,768 |
| Surplus/(Deficits) in the Scheme | (405) | (75) | (91) | 361 | (7) |
| Experience adjustments arising on plan liabilities - gain/(loss) | (464) | (98) | (154) | (178) | (500) |
| Experience adjustments arising on plan assets - gain/(loss) | 510 | 119 | 243 | 560 | 288 |

| *in HK$ million* | RBS 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|
| Present value of funded obligations | 3 | 7 | 7 | 14 | 31 |
| Fair value of plan assets | 12 | 13 | 14 | 14 | 23 |
| Surplus/(Deficits) in the Scheme | 9 | 6 | 7 | — | (8) |
| Experience adjustments arising on plan liabilities - gain/(loss) | 3 | (2) | 5 | 7 | (4) |
| Experience adjustments arising on plan assets - gain/(loss) | — | — | — | — | — |

## 44 Interests in jointly controlled operations

The Group has the following jointly controlled operations in respect of its awarded property development projects as at 30 June 2007.

| Location/Development Package | Land Use | Total Gross Floor Area *(sq m)* | Actual or Expected Date of Completion of Construction Works * |
|---|---|---|---|
| **Hong Kong Station** | Office/Retail/Hotel | 415,894 | Completed by phases from 1998-2005 |
| **Kowloon Station** | | | |
| Package One | Residential | 147,547 | Completed in 2000 |
| Package Two | Residential | 210,319 | Completed by phases from 2002-2003 |
| Package Three | Residential/Cross Border Bus Terminus | 105,113 | Completed in 2005 |
| Package Four | Residential | 128,845 | Completed in 2003 |
| Package Five, Six and Seven | Residential/Office/Retail/Hotel/ Serviced Apartment/Kindergarten | 504,350 | By phases from 2006-2010 |
| **Olympic Station** | | | |
| Package One | Residential/Office/Retail/Indoor Sports Hall | 309,069 | Completed in 2000 |
| Package Two | Residential/Retail/Market | 268,650 | Completed in 2001 |
| Package Three | Residential/Kindergarten | 104,452 | Completed in 2006 |
| **Tsing Yi Station** | Residential/Retail/Kindergarten | 292,795 | Completed in 1999 |
| **Tung Chung Station** | | | |
| Package One | Residential/Office/Retail/Hotel/ Kindergarten | 361,531 | Completed by phases from 1999-2005 |
| Package Two | Residential/Retail/Kindergarten | 255,949 | By phases from 2002-2007 |
| Package Three | Residential/Retail/Wet Market/ Kindergarten | 413,154 | By phases from 2002-2008 |
| **Hang Hau Station** | Residential/Retail | 142,152 | Completed in 2004 |
| **Tiu Keng Leng Station** | Residential/Retail | 253,765 | By phases from 2006-2007 |
| **Tseung Kwan O Station** | | | |
| Area 55b | Residential/Retail | 96,797 | Completed in 2006 |
| Area 57a | Residential/Retail | 29,642 | Completed in 2005 |
| Area 56 | Residential/Hotel/Retail/Office | 163,130 | 2011 |
| **Tseung Kwan O South Station** | | | |
| Area 86 Package One | Residential/Retail/Residential Care Home for the Elderly | 139,840 | 2008 |
| Area 86 Package Two | Residential/Kindergarten | 310,496 | By phases from 2009-2010 |
| **Choi Hung Park-and-Ride** | Residential/Retail | 21,538 | Completed in 2005 |

* Completion based on issuance of occupation permit

The Group's assets held in relation to these joint venture operations include various site foundation works and related staff and overhead costs. The costs incurred by the Group on each development package are set off against any up-front payments received from developers in relation to that development package, and the balance is shown on the balance sheet either as property development in progress or deferred income (note 18) as the case may be. As at 30 June 2007, total property development in progress in respect of these jointly controlled operations was HK$1,884 million (2006: HK$2,028 million; 2005: HK$1,087 million; 2004: HK$388 million) and total deferred income was HK$1,108 million (2006: HK$1,562 million; 2005: HK$3,458 million; 2004: HK$4,506 million).

During the six months ended 30 June 2007, profits of HK$1,664 million (2006: HK$5,817 million; 2005: HK$6,145 million; 2004: HK$4,568 million) were recognised (note 7).

**45 Material related party transactions**

The Financial Secretary Incorporated, which holds approximately 76.7% of the Company's issued share capital on trust for the Government of the Hong Kong SAR, is the majority shareholder of the Company. Transactions between the Group and Government departments, agencies or Government controlled entities, other than those transactions such as the payment of fees, taxes, leases and rates, etc. that arise in the normal dealings between the Government and the Group, are considered to be related party transactions pursuant to HKAS 24 "Related party disclosures" and are identified separately in these accounts.

Members of the Board and Members of the Executive Directorate, and parties related to them including their close family members, are also considered to be related parties of the Group. Transactions with these parties, except for those involving a Member of the Board or his related parties where the relevant Member abstains from voting, are separately disclosed in the accounts.

Major related party transactions entered into by the Group in prior years which are still relevant for the current period include:

***A*** The Company entered into the Airport Railway Agreement with the Government on 5 July 1995 for the construction of the Airport Railway. In addition to specifying the parameters for the design, construction and operation of the Tung Chung and Airport Express Lines, the Agreement also included provisions for the granting of land to the Company for property development (note 18).

***B*** The Company entered into the TKE Project Agreement with the Government on 4 November 1998 for the design, construction, financing and operation of the Tseung Kwan O Extension and the granting of land for commercial and residential property developments along the railway extension.

***C*** On 30 June 2000, the Appointed Day for the purposes of the Mass Transit Railway Ordinance, the Company was granted a franchise, for an initial period of 50 years, to operate the existing mass transit railway, and to operate and construct any extension to the railway. On the same day, the Company entered into an Operating Agreement ("OA") with the Government which detailed provisions for the design, construction, maintenance and operation of the railway under the franchise. Pursuant to the terms of the OA, the Company's franchise will be extended for further periods of 50 years upon satisfying certain capital expenditure requirements at no payment and without any change in the terms of the franchise. The OA also provides that upon extension of the franchise and subject to the Government's prevailing land policy on the date on which the franchise is extended, certain consequential amendments will be made to agreements between the Government and the Company in relation to the mass transit railway, including the renewal of various railway running line leases and land leases at nominal cost.

***D*** On 14 July 2000, the Company received a comfort letter from the Government pursuant to which Government agreed to extend the period of certain of the Company's land interests so that they are coterminous with the Company's initial 50-year franchise.

***E*** On 24 July 2002, the Company entered into an agreement with the Government specifying the parameters for the design, construction, financing and operation of the Disneyland Resort Line ("DRL"). In connection with the financing of the DRL Project, the Government agreed to provide financial support through the Government waivers of its entitlement to cash dividends in respect of its shareholding. Such committed financial support has been met in 2004. The DRL was completed in June 2005 and commenced operation on 1 August 2005.

***F*** On 19 November 2003, the Company entered into a formal project agreement with the Government to develop, on a build, operate and transfer basis, the Tung Chung Cable Car System together with a Theme Village at Ngong Ping on the Lantau Island under a franchise granted by the Government for a period of 30 years commencing on 24 December 2003. The project was completed during 2006 with operation commenced on 18 September 2006. Details of the project are set out in note 17C.

***G*** On 24 January 2005, the Company accepted an offer from the Government to allow the Company to proceed with the proposed development on Site F of Tseung Kwan O Town Lot No. 70, Area 86, at an assessed land premium of HK$2,319 million together with other ancillary terms and conditions as specified in the modification letter to be entered into between the Company and the Government. Upon award of the development package on 8 February 2005, the agreed land premium, of which one-half or HK$1,160 million was paid by the Company, was settled.

***H*** On 18 July 2005, the Company entered into a project agreement with the Airport Authority for the procurement of MTR station extension works and related railway facilities to serve the SkyPlaza at the Hong Kong International Airport. Details of the project are described in note 17E.

During the year/period, the Group has had the following material related party transactions:

***I*** In connection with the construction of various railway projects, certain essential project works are embedded within the infrastructure works to be undertaken by the Government or certain of its related parties. These works have been entrusted to the Government and its related parties and are payable on an actual cost basis according to architectural certifications. The Government and certain of its related parties, on the other hand, have entered into entrustment agreements with the Company for the construction of various other infrastructure works that are also reimbursable according to actual costs certified. Details of the amounts paid and the amounts receivable and payable as at 30 June 2007 are provided in notes 17, 31 and 36 respectively.

***J*** The Company has business transactions with its non-controlled subsidiaries in the normal course of operations. Details of which are disclosed in note 21.

***K*** The Group has paid remuneration to the Members of the Board and Members of the Executive Directorate. Details of these transactions are described in note 6A. In addition, the Members of the Executive Directorate were granted share options under the Company's Pre-Global Offering Share Option Scheme and New Joiners Share Option Scheme. Details of the terms of these directors' options are disclosed in note 6B. Their gross remuneration charged to the profit and loss account is summarised as follows:

| | **Year ended 31 December** | | | **Six months ended 30 June** | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Short-term employee benefits | 44.5 | 42.3 | 38.6 | 16.9 | 16.9 |
| Post-employment benefits | 2.4 | 2.2 | 3.0 | 0.9 | 0.9 |
| Equity compensation benefits | 6.5 | 5.2 | 3.5 | 1.9 | 4.7 |
| | 53.4 | 49.7 | 45.1 | 19.7 | 22.5 |

The above remuneration is included in staff costs and related expenses.

*L* Dividend payments to the Government were as follows:

| *in HK$ million* | Year ended 31 December 2006 | Year ended 31 December 2005 | Year ended 31 December 2004 | Six months ended 30 June 2007 *(unaudited)* | Six months ended 30 June 2006 *(unaudited)* |
|---|---|---|---|---|---|
| Cash dividends paid | 777 | 760 | 652 | 482 | 538 |
| Cash dividends waived | — | — | 37 | — | — |
| Shares allotted in respect of scrip dividends | 990 | 978 | 1,014 | 708 | 637 |
| | 1,767 | 1,738 | 1,703 | 1,190 | 1,175 |

In 2004, HK$37 million cash dividends were waived by the Government. Such amount, together with HK$11 million brought forward from previous year, have been offset against the construction costs of the DRL Project (note 17) for the year.

## 46 Commitments

### *A Capital commitments*

i *Outstanding capital commitments not provided for in the accounts were as follows:*

The Group

| *in HK$ million* | Railway operations | Railway extension projects | Property projects and management | Overseas project | Total |
|---|---|---|---|---|---|
| **At 31 December 2006** | | | | | |
| Authorised but not yet contracted for | 476 | — | 428 | 5 | 909 |
| Authorised and contracted for | 353 | 325 | 676 | 72 | 1,426 |
| | 829 | 325 | 1,104 | 77 | 2,335 |
| **At 31 December 2005** | | | | | |
| Authorised but not yet contracted for | 543 | — | 408 | 8 | 959 |
| Authorised and contracted for | 598 | 67 | 1,336 | 97 | 2,098 |
| | 1,141 | 67 | 1,744 | 105 | 3,057 |
| **At 31 December 2004** | | | | | |
| Authorised but not yet contracted for | 518 | — | 1,762 | — | 2,280 |
| Authorised and contracted for | 927 | 558 | 213 | — | 1,698 |
| | 1,445 | 558 | 1,975 | — | 3,978 |
| **At 30 June 2007 (unaudited)** | | | | | |
| Authorised but not yet contracted for | 898 | — | 587 | — | 1,485 |
| Authorised and contracted for | 301 | 254 | 753 | 341 | 1,649 |
| | 1,199 | 254 | 1,340 | 341 | 3,134 |
| **At 30 June 2006 (unaudited)** | | | | | |
| Authorised but not yet contracted for | 737 | — | 371 | 11 | 1,119 |
| Authorised and contracted for | 610 | 216 | 1,056 | 697 | 2,579 |
| | 1,347 | 216 | 1,427 | 708 | 3,698 |

The Company

| *in HK$ million* | **Railway operations** | **Railway extension projects** | **Property projects and management** | **Total** |
|---|---|---|---|---|
| **At 31 December 2006** | | | | |
| Authorised but not yet contracted for | 476 | — | 428 | 904 |
| Authorised and contracted for | 353 | 325 | 676 | 1,354 |
| | 829 | 325 | 1,104 | 2,258 |
| **At 31 December 2005** | | | | |
| Authorised but not yet contracted for | 543 | — | 408 | 951 |
| Authorised and contracted for | 598 | 67 | 1,336 | 2,001 |
| | 1,141 | 67 | 1,744 | 2,952 |
| **At 31 December 2004** | | | | |
| Authorised but not yet contracted for | 518 | — | 1,762 | 2,280 |
| Authorised and contracted for | 927 | 558 | 213 | 1,698 |
| | 1,445 | 558 | 1,975 | 3,978 |
| **At 30 June 2007 (unaudited)** | | | | |
| Authorised but not yet contracted for | 898 | — | 587 | 1,485 |
| Authorised and contracted for | 301 | 254 | 753 | 1,308 |
| | 1,199 | 254 | 1,340 | 2,793 |
| **At 30 June 2006 (unaudited)** | | | | |
| Authorised but not yet contracted for | 737 | — | 371 | 1,108 |
| Authorised and contracted for | 610 | 216 | 1,056 | 1,882 |
| | 1,347 | 216 | 1,427 | 2,990 |

Included in the amounts authorised but not yet contracted for are costs that will not be subject to capital contracts such as staff costs, overhead expenses and capitalised interest.

ii *The commitments under railway operations comprise the following:*

The Group and The Company

| *in HK$ million* | **Improvement and enhancement works** | **Acquisition of property, plant and equipment** | **Total** |
|---|---|---|---|
| **At 31 December 2006** | | | |
| Authorised but not yet contracted for | 454 | 22 | 476 |
| Authorised and contracted for | 349 | 4 | 353 |
| | 803 | 26 | 829 |
| **At 31 December 2005** | | | |
| Authorised but not yet contracted for | 479 | 64 | 543 |
| Authorised and contracted for | 259 | 339 | 598 |
| | 738 | 403 | 1,141 |
| **At 31 December 2004** | | | |
| Authorised but not yet contracted for | 388 | 130 | 518 |
| Authorised and contracted for | 232 | 695 | 927 |
| | 620 | 825 | 1,445 |
| **At 30 June 2007 (unaudited)** | | | |
| Authorised but not yet contracted for | 870 | 28 | 898 |
| Authorised and contracted for | 291 | 10 | 301 |
| | 1,161 | 38 | 1,199 |
| **At 30 June 2006 (unaudited)** | | | |
| Authorised but not yet contracted for | 680 | 57 | 737 |
| Authorised and contracted for | 438 | 172 | 610 |
| | 1,118 | 229 | 1,347 |

***B Operating lease commitments***

The Group had operating leases on office buildings, staff quarters, and a shopping centre in Beijing since April 2006. The total future minimum lease payments under non-cancellable operating leases are payable as follows:

The Group

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Payable within one year | 53 | 8 | 7 | 53 | 53 |
| Payable after one but within five years | 250 | 3 | 1 | 231 | 266 |
| | 303 | 11 | 8 | 284 | 319 |

The Company

| | At 31 December | | | At 30 June | |
|---|---|---|---|---|---|
| *in HK$ million* | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Payable within one year | 5 | 8 | 7 | 5 | 5 |
| Payable after one but within five years | 5 | 3 | 1 | 2 | 4 |
| | 10 | 11 | 8 | 7 | 9 |

The above includes HK$1 million (2006: HK$2 million; 2005: HK$1 million; 2004: HK$2 million) in respect of the office accommodation and quarters for construction project staff, majority of which are subject to rent reviews. The Group has the right to acquire the shopping centre in Beijing at a pre-determined price during the first five years of the lease term, which commenced from April 2006, or release its obligation as a tenant by making a compensation to the landlord upon expiry of the fifth year.

***C Liabilities and commitments in respect of property management contracts***

The Group has, over the years, jointly developed with outside property developers certain properties above or adjacent to railway depots and stations. Under most of the development agreements, the Group retained the right to manage these properties after their completion. The Group, as manager of these properties, enters into services contracts with outside contractors for the provision of security, cleaning, maintenance and other services on behalf of the managed properties. The Group is primarily responsible for these contracts, but any contract costs incurred will be reimbursed by the owners and tenants of the managed properties from the management funds as soon as they are paid.

As at 30 June 2007, the Group had total outstanding liabilities and contractual commitments of HK$761 million (2006: HK$773 million; 2005: HK$619 million; 2004: HK$613 million) in respect of these works and services. Cash funds totalling HK$837 million (2006: HK$788 million; 2005: HK$695 million; 2004: HK$665 million) obtained through monthly payments of management service charges from the managed properties are held by the Group on behalf of those properties for settlement of works and services provided.

***D Material financial guarantee contracts***

As at 30 June 2007, the Company provides guarantees to investors of debt securities issued by one of its subsidiaries, MTR Corporation (C.I.) Limited (note 33D), which amounted to approximately HK$11,531 million (2006: HK$11,515 million). As proceeds from such debts issued have been on lent to the Company, the primary liabilities have already been recorded in the Company's balance sheet.

## 47 Investments in China and Europe

### *A Investment in China*

i *Investment in Line 4 of Shenzhen Metro System ("Shenzhen Line 4")*

In January 2004, the Group entered into an Agreement in Principle for a Build-Operate-Transfer ("BOT") project with the Shenzhen Municipal People's Government in respect of the construction of Phase 2 of Shenzhen Line 4 of the proposed Shenzhen Metro System and the operation of the entire line for a term of 30 years. In May 2005, the Group and the Shenzhen Municipal People's Government initialed the project Concession Agreement. The project is subject to approval from the Central Government.

Shenzhen Line 4 is a 21-km urban railway running from Huanggang to Longhua New Town in Shenzhen, forming the major north-south railway corridor of the Shenzhen Special Economic Zone. Upon completion of Phase 2 of Shenzhen Line 4, both Phases 1 and 2 will be operated by the Company's subsidiary established in Shenzhen. Total investment of the project is estimated at RMB 6.0 billion (HK$6.2 billion) which will be financed by equity capital contributed by the Group of RMB 2.4 billion (HK$2.5 billion) and the balance by non-recourse bank loans in Renminbi.

Preparatory work including design and tendering is in progress and expended trial section work has begun. As at 30 June 2007, costs of HK$400 million (2006: HK$282 million; 2005: HK$166 million; 2004: HK$51 million) incurred for the project have been included in deferred expenditure and the Group had other contract commitments totalling HK$341 million (2006: HK$77 million; 2005: HK$105 million; 2004: HK$10 million) in relation to this project.

ii *Investment in Beijing Metro Line 4 Project ("Beijing Line 4")*

In December 2004, an Agreement in Principle was entered into between the Group, Beijing Infrastructure Investment Co. Ltd ("BIIC") and Beijing Capital Group ("BCG"), both are subsidiaries of the Beijing Municipal People's Government, to form a public-private partnership company ("PPP") for the investment in the Beijing Line 4 project, which involves the investment, construction and operation of the line for a term of 30 years. In September 2005, approval from the Central Government for the project was obtained and the PPP, Beijing MTR Corporation Limited, completed all registration requirements and obtained its business license in January 2006. In April 2006, Concession Agreement with the Beijing Municipal People's Government was signed.

Beijing Line 4 is a 29-km underground metro line running from Majialou Station to Longbeicun Station, forming a main north-south traffic artery of Beijing. The total investment for the Beijing Line 4 project is estimated at RMB 15.3 billion (HK$15.7 billion), of which 70% will be borne by the Beijing Municipal People's Government to finance mainly land acquisition and civil construction. Total investment by the PPP is RMB 4.6 billion (HK$4.7 billion), contributing to 30% of the total investment in the project to finance mainly the electrical and mechanical systems and rolling stock. Both the Group and BCG each owns 49% interests of the PPP whilst BIIC owns the remaining 2% interest. The PPP is to operate and be responsible for maintenance of Beijing Line 4 for a term of 30 years. The PPP has a registered capital of RMB 1.4 billion (HK$1.4 billion), of which RMB 676 million (HK$694 million) will be contributed and owned by the Group. As of 30 June 2007, the Group has made an equity contribution of HK$203 million, representing about 30% of the registered capital committed by the Group. Apart from equity, the PPP's investment is financed by non-recourse bank loans provided by Industrial and Commercial Bank of China and China Development Bank.

Tenders for the provision of trains and related electrical and mechanical systems were nearly completed. As of 30 June 2007, a total of 53 contracts including rolling stock, signaling and automatic fare collection system, communications, power supply and environmental control system have been awarded. Rolling stock and other equipment are being manufactured. As at the same date, the PPP has total outstanding capital commitments amounting to approximately RMB1.7 billion (HK$1.7 billion) (2006: RMB1.9 billion; 2005: nil; 2004: nil) in respect of the contracts awarded. Construction is expected to be completed by 2009.

***B Investments in Europe***

On 19 June 2007, the Mayor of London announced that MTR Laing Metro Limited (now renamed as London Overground Railway Operations Limited ("LORO")), a 50/50 joint venture owned by MTR Corporation Limited and Laing Rail Limited in United Kingdom, has been awarded the concession to operate the new London Overground service in Greater London for seven years from November 2007 with an option for a further two-year extension. With a total route network of 107.2 km, London Overground is a semi-orbital route of five railway lines serving West, North and East London and is expected to act as a crucial link for the 2012 Olympic Games. Overseen by Transport for London, the concession is a cost based operating concession from which a fee will be earned by LORO.

## 48 Accounting estimates and judgements

***A Key sources of accounting estimates and estimation uncertainty include the following:***

i *Estimated useful life and depreciation of property, plant and equipment*

The Group estimates the useful lives of the various categories of property, plant and equipment on the basis of their design lives, planned asset maintenance programme and actual usage experience. Depreciation is calculated using the straight-line method at rates sufficient to write off their cost or valuation over their estimated useful lives (note 2H).

ii *Impairment of long-lived assets*

The Group reviews its long-lived assets for indications of impairment at each balance sheet date according to accounting polices set out in note 2G(ii). In analysing potential impairments identified, the Group uses projections of future cash flows from the assets based on management's assignment of a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

iii *Pension costs*

The Group employs independent valuation professionals to conduct annual assessment of the actuarial position of the Group's retirement plans. The determination of the Group's obligation and expense for the defined benefit element of these plans is dependent on certain assumptions and factors provided by the Company, which are disclosed in notes 42A(iii) and 42B.

iv *Revenue recognition on property development*

Recognition of property development profits requires management's estimation of the final project costs upon completion and, in the case of property distribution-in-kind, the properties' fair value upon recognition. The Company takes into account independent qualified surveyors report, past experience on sales and marketing costs, as well as the prevailing market conditions when estimating final project costs on completion, and bases on professionally qualified valuers' reports in determining the estimated fair value of property distribution-in-kind.

v *Properties held for sale*

The Group values unsold properties at the lower of their costs or net realisable values (note 26) at the balance sheet date. In ascertaining the properties' net realisable values, which are represented by the estimated selling prices less costs to be incurred in relation to the sales, the Group employs independent valuation professionals to assess the properties' estimated selling prices, and makes estimations on further selling and property holding costs to be incurred based on past experience and with reference to general market practice.

vi *Interest-free loan to a property developer*

The Group estimated the fair value of the interest-free loan to a developer at its present value discounted at the prevailing market rates of interest at inception.

vii *Valuation of investment properties*

The valuation of investment properties requires management's input of various assumptions and factors relevant to the valuation. The Group conducts annual revaluation of its investment properties by independent professionally qualified valuers based on these assumptions agreed with the valuers prior to adoption.

viii *Franchise*

The current franchise under which the Group is operating allows it to run the mass transit railway system until 30 June 2050. Pursuant to the terms stipulated in the Operating Agreement with the Government, the Company considers that it has the legal right to extend the franchise for further periods of 50 years upon expiry of each franchise term (note 45C). The Group's depreciation policies (note 2H) in respect of certain assets' lives which extend beyond 2050 are on this basis.

ix *Income tax*

Certain treatments adopted by the Company in its tax returns in the past years are yet to be finalised with the Hong Kong Inland Revenue Department. In assessing the Company's income tax and deferred taxation in the accounts, the Company has followed the tax treatments it has adopted in those tax returns, which may be different from the final outcome in due course.

x *Project provisions*

The Group establishes project provisions for the settlement of estimated claims that may arise due to time delays, additional costs or other unforeseen circumstances common to major construction contracts. The claims provisions are estimated based on an assessment of the Group's liabilities under each contract by professionally qualified personnel, which may differ from the actual claims settlement.

xi *Deferred expenditure*

As disclosed in note 2I(i), the Group capitalises proposed railway project costs in deferred expenditure when the projects are at a detailed study stage and having been approved in principle by the Members of the Board. Such decision involves the Board's judgement on the outcome of the proposed project.

xii *Fair value of derivatives and other financial instruments*

In determining the fair value of financial instruments, the Group uses its judgement to select a variety of methods and make assumptions that are mainly based on market conditions existing at each balance sheet date. For financial instruments that are not traded in active markets, the fair values were based on the discounted cash flows method which discounts the future contractual cash flows at the current market interest or foreign exchange rates, as applicable, for similar financial instruments that were available to the Group at the time.

***B Critical accounting judgements in applying the Group's accounting policies***

i *Provisions and contingent liabilities*

The Group recognises provisions for liabilities of uncertain timing or amount when the Group has a legal or constructive obligation arising as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made. Where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably, the obligation is disclosed as contingent liability. As at 30 June 2007, the Group considered that it had no disclosable contingent liabilities as there were neither pending litigations nor events with potential obligation which were probable to result in material outflow of economic benefits to the Group.

ii *Non-controlled subsidiaries*

The Company regards Octopus Holdings Limited and its subsidiaries (the "OHL Group") as non-controlled subsidiaries. In determining whether the Group has control over these subsidiaries, the Company has taken into account its voting right conferred to it under the Shareholder's Agreement of OHL and the effective influence it may exercise over the decision of OHL's Board. Throughout the years ended 31 December 2006, 2005 and 2004, and six months ended 30 June 2007 and 2006, the Group considered that its voting right in the OHL Group has been maintained at 49% despite an equity interest of 57.4%. As such, the OHL Group of companies were accounted for as non-controlled subsidiaries in the Group's accounts.

## 49 Possible impact of amendments, new standards and interpretations issued but not yet effective for the accounting period ended 30 June 2007

The HKICPA has issued a number of amendments, new standards and interpretations which are not yet effective for the six months ended 30 June 2007 and which have not been adopted in these accounts. The Group considered that the following new standards will apply to its accounts in future.

| | **Effective for accounting periods beginning on or after** |
|---|---|
| HK(IFRIC) Interpretation 12 "Service Concession Arrangements" | 1 January 2008 |

The adoption of HK(IFRIC) Interpretation 12, which prescribes the accounting treatments for service concession arrangements in respect of infrastructure for public services, is currently not considered to have an effect but may have an impact to the Group's future operations. The Group is carrying out an assessment to identify the likely implications this new Interpretation may have on the its accounts should service concession arrangements be entered into in future.

## F. MANAGEMENT'S DISCUSSION AND REVIEW OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the Group's audited consolidated accounts for the years ended 31 December 2004, 2005 and 2006, as well as unaudited interim financial reports for the six months ended 30 June 2006 and 2007, together with the notes thereto included elsewhere in this Circular.

### Overview

The Group's financial strategy is to generate sufficient revenues from customers to cover operating costs, maintain and improve the quality of plant and equipment, service and repay debt and earn a reasonable rate of return for its shareholders. The Group's principal sources of revenue are railway and related operations (including fare revenue, station commercial revenue, advertising, kiosk rental, consultancy services, telecommunication coverage income and other income related to the operation of the railway), property ownership and management, property development and, commencing September 2006, operations relating to Ngong Ping 360.

The Group's results of operations are generally affected by, among other factors, patronage, fare levels, competition, the state of the Hong Kong economy, consumer preferences among transportation modes and frequency of travel and demographic trends. Moreover, the Airport Express's contribution to fare revenue is principally driven by tourist arrivals and departures.

In conjunction with its railway construction activities, the Group has been involved in the development of residential and commercial properties above and adjacent to MTR stations and depots under agreements with various property developers. The amount and timing of property development profits have been largely driven by the scale and progress of various property developments associated with new railway projects with which the Group has been involved as well as the state of the property market in Hong Kong.

The Group's principal railway operating costs are depreciation costs, staff costs and related expenses, energy and utilities costs and repairs and maintenance costs. The Group's staff costs are influenced by inflation, labour productivity, the relative supply and demand for labour in Hong Kong and other factors. Energy costs are influenced by car miles operated, asset efficiency, electricity tariffs and other factors. In addition, the Group's rapidly expanding consultancy service activities, operation of the newly opened Ngong Ping 360 and the expanded property rental and management activities have resulted in significant expenses relating to station commercial and other businesses and property ownership and management expenses. Furthermore, the increased business development activities in Hong Kong, Mainland of China and Europe have led to higher project studies and business development expenses in recent years.

The Group has historically relied on equity injections from the Government, debt financing and funds from railway and related operations and property development profits to finance the construction and operation of the MTR and it is possible that future major railway projects will be financed by a mixture of funds from these different sources. The level of the Group's indebtedness reflects a decision by the Group as to an appropriate ratio of debt to shareholder funds, which takes into account the Group's cash requirements and the impact of additional indebtedness on its credit ratings and costs of debt financing.

**Results of Operations**

The following table sets forth the Group's operating results for the years/periods indicated:

Consolidated profit and loss account (HK$ million)

| | For the years ended 31 December | | | For the six months ended 30 June | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** *(unaudited)* | **2006** *(unaudited)* |
| Revenue | 9,541 | 9,153 | 8,351 | 4,852 | 4,566 |
| Operating expenses | (4,340) | (4,052) | (3,822) | (2,055) | (1,927) |
| **Operating profit from railway and related businesses before depreciation** | 5,201 | 5,101 | 4,529 | 2,797 | 2,639 |
| Profit on property developments | 5,817 | 6,145 | 4,568 | 1,664 | 4,072 |
| **Operating profit before depreciation** | 11,018 | 11,246 | 9,097 | 4,461 | 6,711 |
| Depreciation | (2,674) | (2,682) | (2,499) | (1,348) | (1,315) |
| **Operating profit before interest and finance charges** | 8,344 | 8,564 | 6,598 | 3,113 | 5,396 |
| Interest and finance charges | (1,398) | (1,361) | (1,450) | (654) | (739) |
| Change in fair value of investment properties | 2,178 | 2,800 | 2,486 | 2,450 | 1,478 |
| Share of profits less losses of non-controlled subsidiaries and associates | 45 | 9 | 39 | 42 | 16 |
| **Profit before taxation** | 9,169 | 10,012 | 7,673 | 4,951 | 6,151 |
| Income tax | (1,411) | (1,549) | (1,130) | (879) | (984) |
| **Profit for the year/period** | 7,758 | 8,463 | 6,543 | 4,072 | 5,167 |
| **Attributable to:** | | | | | |
| — Equity shareholders of the Company | 7,759 | 8,450 | 6,543 | 4,071 | 5,167 |
| — Minority interests | (1) | 13 | — | 1 | — |
| **Profit for the year/period** | 7,758 | 8,463 | 6,543 | 4,072 | 5,167 |
| **Dividends paid and proposed to equity shareholders of the Company attributable to the year/period:** | | | | | |
| — Interim dividend declared and paid during the year/period | 774 | 764 | 750 | 782 | 774 |
| — Final dividend proposed after the balance sheet date | 1,554 | 1,535 | 1,509 | — | — |
| | 2,328 | 2,299 | 2,259 | 782 | 774 |
| **Earnings per share:** | | | | | |
| — Basic | HK$1.41 | HK$1.55 | HK$1.23 | HK$0.73 | HK$0.94 |
| — Diluted | HK$1.41 | HK$1.55 | HK$1.23 | HK$0.73 | HK$0.94 |

**Six months ended 30 June 2007 compared to six months ended 30 June 2006**

Total revenue for the first six months ended 30 June 2007 increased by 6.3% to HK$4,852 million from the same period in 2006. Fare revenue increased by 3.5% to HK$3,247 million compared to HK$3,138 million for 2006, mainly attributable to patronage increases of 2.6% for the MTR LInes and 7.2% for Airport Express. Average fare for the MTR Lines increased by 0.6% to HK$6.84, whilst average fare for Airport Express declined slightly by 0.6% to HK$64.40.

Non-fare revenue including station commercial, property rental and management and others rose by 12.4% to HK$1,605 million as the economic growth and strong retail market helped increase revenue from advertising, station commercial facilities and rentals from our properties, while additional income streams were generated from the new Ngong Ping 360 operations as well as the expanded property rental and management portfolio in Hong Kong and Beijing.

Operating costs before depreciation for the first half of 2007 increased by 6.6% to HK$2,055 million as compared with the same period last year, mainly attributable to the expansion in property rental, management and other businesses, increase in business development in Europe and China as well as an one-off refund of operational rent and rates in 2006 which was not repeated in 2007. Operating profit from railway and related businesses before depreciation was HK$2,797 million, a 6.0% increase from the same period last year. The operating profit margin decreased marginally from 57.8% in the first half of 2006 to 57.6% in 2007.

Property development profit for the first half of 2007 amounted to HK$1,664 million, mainly comprising surplus proceeds from Harbour Green and Caribbean Coast along the Airport Railway as well as deferred income recognition from Coastal Skyline, Caribbean Coast and Elements along the Airport Railway. Operating profit before depreciation amounted to HK$4,461 million, a decrease of 33.5% from the same period last year due to a decrease in property development profits where in the first half of 2006 substantial surplus proceeds were recognised from The Grandiose and Metro Town developments along the Tseung Kwan O Line.

Depreciation charge for the first half of 2007 increased by 2.5% to HK$1,348 million compared with the same period in 2006, mainly due to the addition of depreciation charge for Ngong Ping 360 which commenced operation in September 2006.

With the reduction in total borrowings, net interest expense decreased by 11.5% to HK$654 million as compared with the same period last year.

The increase in fair value of investment properties since the end of 2006 amounted to HK$2,450 million pre-tax and HK$2,021 million post-tax.

Including the share of profit from Octopus Holdings Limited of HK$42 million, profit before taxation decreased by 19.5% to HK$4,951 million when compared with the same period last year.

Income tax correspondingly decreased by 10.7% to HK$879 million, which was wholly non-cash deferred income tax. Net profit attributable to shareholders of the Company for the first half of 2007 therefore amounted to HK$4,071 million, with reported earnings per share of HK$0.73. Excluding investment property revaluation gain and related deferred tax, underlying net profit was HK$2,050 million while earnings per share were HK$0.37.

The Directors have declared an interim dividend of HK$0.14 per share, which is the same as in 2006. As with previous dividend payments, a scrip dividend option will be offered to all shareholders except those with registered addresses in the United States of America or any of its territories or possessions. The Company's majority shareholder, the Financial Secretary Incorporated, has agreed to receive all or part of its entitlement to dividends in the form of scrip to the extent necessary to ensure that a maximum of 50% of the total dividend paid by the Company will be paid in the form of cash.

**Year ended 31 December 2006 compared to year ended 31 December 2005**

Revenue increased by 4.2% to HK$9,541 million in 2006 from HK$9,153 million in 2005. This increase was primarily due to the growth in patronage and full-year effect of the Disney Resort Line ("DRL") operation, as well as increases in station commercial and other revenue and rental and management income.

Total fare revenue increased by 3.8% to HK$6,523 million in 2006 from HK$6,282 million in 2005. Fare revenue from the MTR Lines increased by 3.3% to HK$5,911 million as a result of a 1.0% growth in patronage to 867 million, and a 2.2% increase in average fare to HK$6.82 due to the full-year effect of both the changes in certain promotion programs and the opening of DRL operations. Fare revenue from the Airport Express also increased by 9.1% to HK$612 million in 2006, as compared to HK$561 million in 2005 due to a patronage increase of 12.8% to 9.6 million resulting from growth in air-passengers and the full-year effect of the opening of the AsiaWorld-Expo ("AWE") Station, partly offset by a 3.4% decline in average fare to HK$63.85 attributable to the lower average fare for passengers traveling to and from the AWE Station.

Station commercial and rail related businesses revenue decreased marginally by 0.8% to HK$1,542 million in 2006 from HK$1,555 million in 2005 mainly attributable to a reduction in telecommunication income partly offset by growth in advertising income and kiosk rental.

Rental, management and other business income increased by 12.2% to HK$1,476 million in 2006 from HK$1,316 million in 2005 as a result of higher rental rates achieved upon re-letting and renewal, increased turnover rent received, full-year operation of a new shopping centre and the opening of the Choi Hung Park and Ride and The Edge in 2006, as well as the expansion of the management portfolio. In addition, there was revenue from Ngong Ping 360 which opened in September 2006.

Total operating expenses increased by 7.1% to HK$4,340 million in 2006 from HK$4,052 million in 2005. Staff costs and related expenses rose by 2.4% to HK$1,653 million during 2006 mainly due to annual salary increase. Expenses related to station commercial and rail related businesses increased as a result of higher consultancy expenses and growth of business activities while property ownership and management expenses also increased due to business expansion in Hong Kong and expenditures for Ginza Mall in Beijing. Project studies and business development expenses increased by HK$125 million to HK$267 million in 2006 due to increased development activities in Hong Kong, Mainland of China and Europe, as well as the Ngong Ping 360 project.

As a result of the foregoing, operating profit from railway and related businesses before depreciation increased by 2.0% to HK$5,201 million in 2006, from HK$5,101 million in 2005. The operating margin (operating profit from railway and related businesses before depreciation divided by revenue) reduced slightly to 54.5% in 2006 from 55.7% in 2005.

The Group recognised property development profit of HK$5,817 million in 2006 compared to HK$6,145 million in 2005. These profits mainly comprise surplus proceed and recognition of deferred income from the Tseung Kwan O and Airport Railway property projects, as well as sharing-in-kind in respect of an additional floor area of 7,609 square metres at Elements at Kowloon Station.

As a result of the foregoing, operating profit before depreciation reduced slightly by 2% to HK$11,018 million compared to HK$11,246 million in 2005.

Depreciation charge for 2006 amounted to HK$2,674 million compared to HK$2,682 million in 2005, after accounting for the addition of Ngong Ping 360 and other new assets, as well as the full-year depreciation charge in 2006 for DRL and the AWE Station, more than offset by the termination of depreciation on certain assets which have been fully depreciated.

Interest and finance charges (net of interest income) increased by 2.7% to HK$1,398 million from HK$1,361 million in 2005 owing to the rise in interest rates and the expensing of interest costs relating to DRL and the AWE Station which are no longer capitalised.

In compliance with the Hong Kong Accounting Standard ("HKAS") 40 on revaluation of investment properties, the increase in market value of our investment properties in 2006 of HK$2,178 million was recognised in the profit and loss account compared to an amount of HK$2,800 million recognised in 2005.

The Group's share of profits less losses of non-controlled subsidiaries and associates increased to HK$45 million in 2006 from HK$9 million in 2005 primarily due to an increase of 70% on the Group's share in Octopus Holdings Limited's profit.

Income tax expense, comprising mainly deferred tax provision, decreased by 8.9% to HK$1,411 million in 2006 from HK$1,549 million in 2005 mainly due to lower deferred tax expense on the change in fair value on investment properties in 2006. No provision for current Hong Kong Profits Tax has been made as the Company and its subsidiaries either had substantial accumulated tax losses brought forward which are available for set off against current year's assessment profits or have sustained tax losses as of year end.

As a result of the foregoing, the Group had a net profit of HK$7,758 million in 2006 compared to HK$8,463 million in 2005, with a net profit attributable to equity shareholders of HK$7,759 million in 2006 compared to HK$8,450 million in 2005. Earnings per share correspondingly decreased to HK$1.41 in 2006 from HK$1.55 in 2005.

The Company paid an interim dividend of HK$774 million, or HK$0.14 per share, on 27 October 2006. A final dividend of HK$1,554 million, or HK$0.28 per share, with a scrip dividend option offered to all shareholders except those with registered addresses in the United States of America or any of its territories or possessions. The scrip alternative allows shareholders to receive all or a portion of their dividend in shares as opposed to cash. As in previous years, The Financial Secretary Incorporated ("FSI") has agreed to receive its entitlement to dividends in the form of shares to the extent necessary to ensure that a maximum of 50% of the Company's total dividend will be paid in cash.

**Year ended 31 December 2005 compared to year ended 31 December 2004**

Revenue increased by 9.6% to HK$9,153 million in 2005 from HK$8,351 million in 2004. This increase was primarily due to an increase in fare revenue on both the MTR Lines and Airport Express, as well as an increase in station commercial and rail related revenue and rental and management income.

Total fare revenue increased by 5.9% to HK$6,282 million in 2005 from HK$5,932 million in 2004. In particular, fare revenue for the MTR Lines increased by 5.6% to HK$5,721 million in 2005 from HK$5,417 million in 2004, while fare revenue for the Airport Express increased by 8.9% to HK$561 million from HK$515 million in 2004. These increases were principally due to an increase in patronage on both the MTR Lines and the Airport Express owing to the sustained economic growth in 2005, and due to an increase of the average fare on both the MTR Lines and the Airport Express resulting from a change in fare promotion and longer distance journey taken by passenger respectively.

Station commercial and rail related revenue increased by 18.6% to HK$1,555 million in 2005 from HK$1,311 million in 2004. This increase was mainly due to an increase in advertising income, telecommunications income, including a one-time payment by a mobile phone operator for the early termination of a mobile phone system contract, and consultancy income, as well as increases in rental income from additional kiosks as a result of station renovations.

Rental and management incomes increased by 18.8% to HK$1,316 million in 2005 from HK$1,108 million in 2004. This increase was primarily due to an increase in rental income related to the opening of a new shopping centre and the full-year effect of office and car park rental income at Two International Finance Centre, higher rental renewal rates, as well as higher revenue from property management resulting from an expansion of the managed portfolio.

Total operating expenses increased by 6.0% to HK$4,052 million in 2005, from HK$3,822 million in 2004. This increase was primarily due to increases in staff costs and related expenses resulting from new staffing requirements in connection with the network expansion, increases in salary and special discretionary awards, increases in operational rent and rates, increases in expenses relating to station commercial and other businesses in line with increases in business activity, increases in general and administration expenses in connection with various business strategy and efficiency improvement studies, and a HK$69 million one-time write-back of a revaluation deficit of self-occupied properties in 2004. This increase was partially offset by decreases in project study and business development expenses as a result of the write-off of certain project study expenses relating to various extension projects in 2004, and the effect of a new accounting treatment, pursuant to which, effective 1 January 2005, rail repairs and replacement costs are capitalised as fixed assets on the balance sheet thereby reducing operating expenses by HK$45 million in 2005 and increasing depreciation expenses by HK$75 million in 2005.

As a result of the foregoing, operating profit from railway and related businesses before depreciation increased by 12.6% to HK$5,101 million in 2005 from HK$4,529 million in 2004. The operating margin from railway and related businesses increased to 55.7% in 2005 from 54.2% in 2004.

The Group recognised property development profits of HK$6,145 million in 2005 compared to HK$4,568 million in 2004. These profits were primarily attributable to profits recognised from deferred income and sharing of profits and assets in kind in respect of certain Airport Railway developments, as well as the Group's share of surplus from development in line with the construction and sales progress on property developments along the Airport Railway and the Tseung Kwan O Line, including in particular the Group's share of surplus from development of The Arch.

Depreciation increased by 7.3% to HK$2,682 million in 2005 from HK$2,499 million in 2004. This increase was primarily due to the effect of the abovementioned new accounting treatment on rail repairs and replacement costs, the full depreciation of certain telecommunications equipment due to the early termination of a mobile system contract, the completion of the DRL, as well as depreciation on new railway assets including platform screen doors and station improvement works.

Interest and finance charges decreased by 6.1% to HK$1,361 million in 2005 compared to HK$1,450 million in 2004. This decrease was primarily due to lower levels of borrowing, which was partially offset by an increase in interest rates in 2005, which increased the average cost of borrowing.

As required under HKAS 40, the Group recognised a change in the fair value of investment properties of HK$2,800 million in 2005 and HK$2,486 million in 2004.

The Group's share of profits less losses of non-controlled subsidiaries and associates decreased by 76.9% to HK$9 million in 2005 from HK$39 million in 2004, primarily as a result of the Group's share in the net losses of associates in 2005, which partially offset the Group's share of Octopus Holdings Limited's net profit, which increased by 2.6% to HK$40 million in 2005 from HK$39 million in 2004.

Income tax expenses increased by 37.1% to HK$1,549 million in 2005 compared to HK$1,130 million in 2004, mainly due to higher deferred tax expense on the change in fair value of investment properties and taxable property development profits in 2005.

No provision for current Hong Kong Profits Tax has been made, as the Company and its subsidiaries either had substantial accumulated tax losses brought forward which are available for set off against current year's assessable profits or have sustained tax losses as of year end.

As a result of the foregoing, the Group had a net profit of HK$8,463 million in 2005, compared to HK$6,543 million in 2004, with a net profit attributable to equity shareholders of HK$8,450 million in 2005, compared to HK$6,543 million in 2004.

The Company paid an interim dividend of HK$764 million, or HK$0.14 per share, on 27 October 2005. A final dividend for 2005 of HK$1,535 million, or HK$0.28 per share, was approved by the Company's shareholders at the annual general meeting on 8 June 2006. The interim dividend included a scrip alternative for shareholders with Hong Kong addresses, whereas the final dividend includes a scrip alternative for all shareholders (except shareholders with registered addresses in the United States of America or any of its territories or possessions). In order to ensure that a maximum of 50% of the total dividend paid by the Company will be in the form of cash, the Government elected to receive a portion of its entitlement in scrip form.

**Financing**

The Company has historically relied on equity injections from the Government, debt financings, funds from railway and related operations and property development profits to finance both its operating and capital requirements.

The Company believes it is a premier Asian corporate borrower and is an active borrower in the local banking and debt capital markets. It has also from time to time tapped the international debt markets. The Company was the first Hong Kong corporate entity to obtain internationally recognised credit ratings and has since maintained strong ratings on par with those of the Government. As such, it believes it is widely recognised as a leading benchmark for Hong Kong corporate borrowers.

Its credit ratings at present are shown in the table below:

| Credit rating agency | Short-term ratings* | Long-term ratings* |
|---|---|---|
| Standard & Poors | A-1+/A-1+ | AA/AA |
| Moody's | -/P-1 | Aa2/Aa2 |
| Rating and Investment Information Inc. | a·1+/- | AA/AA |

* *Ratings for Hong Kong dollar/foreign currency denominated debts respectively.*

After the passage of the Rail Merger Ordinance on 8 June 2007, Rating & Investment Inc. announced on 4 July 2007 that it had affirmed the Company's foreign currency issuer and Hong Kong dollar issuer ratings at AA with a stable rating outlook citing the content of the Rail Merger as being reasonable to the Company.

On 16 July 2007, Standard & Poor's announced that it had affirmed the Company's foreign currency issuer and senior unsecured debt ratings at AA with a stable outlook, after taking into account the potential merger between the operations of the Company and KCRC and assuming the terms set out in the Memorandum of Understanding would be reflected in the final terms and conditions of the Rail Merger.

On 16 July 2007, Moody's also affirmed the Company's current ratings of Aa3 and announced that it continued to review these ratings for possible upgrade following LegCo's approval of the primary legislation for the Rail Merger.

On 26 July 2007, Moody's upgraded the Company's foreign currency issuer and senior unsecured debt ratings to Aa2 from Aa3 with a stable rating outlook following its decision to upgrade the Government's ratings to Aa2.

Also on 26 July 2007, Standard & Poor's announced it had revised its outlook on the Company's local and foreign currency long-term credit ratings to positive from stable at the same time reaffirming the Company's long-term credit ratings at AA following a corresponding revision to the outlook on the Government.

The Company enters into and uses a wide range of financing and hedging transactions and instruments, including listed and unlisted debt securities, syndicated and bilateral loans, export credits and derivative instruments. It maintains a policy of using derivative instruments for the purposes of risk management only and believes it has developed a comprehensive framework and prudent guidelines and procedures to control its derivatives activities.

These activities include entering into interest rate and currency derivatives transactions to hedge against exposures arising from borrowings and from foreign currency denominated contracts. In addition, it has adopted a comprehensive credit risk management framework based on the Value-at-Risk approach for monitoring counterparty credit exposure arising from these activities.

In raising and managing its debt financings, the Company follows its well-established Preferred Financing Model, which seeks to diversify risks by specifying the preferred mix of fixed and floating rate debt, the permitted level of currency exposure, a well-balanced spread of maturities, the use of different types of financing instruments and an adequate length of financing horizon. In doing so, the Company was able to maintain a well-diversified debt portfolio with adequate forward coverage of its future funding requirement.

**Capital Requirements**

The Company expects to have a total capital expenditure of HK$12.8 billion between 2007 and 2009 covering requirements for the existing railway and property development including Elements, enabling works for Tseung Kwan O South Station and common infrastructure works for Area 86 development sites, as well as Shenzhen Metro Line 4 project cost and equity investment for the Beijing Line 4 project. The financing of this expenditure is expected to be provided by funds generated from railway and related operations, property development profits and debt financing.

In 2006, the Group raised a total of HK$4.1 billion of new financings. These comprised a HK$500 million 2-year fixed rate note, a HK$1.0 billion 3-year fixed rate note, and a total of HK$2.6 billion in bilateral bank loans of five and seven years maturities.

As at 30 June 2007, the Group had total undrawn committed facilities of HK$6.3 billion at its disposal to finance its future capital expenditure, debt refinancing and other requirements.

**Liquidity**

The Group's liquidity is dependent upon its results of operations as well as its capital requirements. In addition, the Group's liquidity is subject to a variety of other factors, including those relating to interest rates and rates of currency exchange. The Group anticipates that a portion of its future borrowings will bear interest at floating rates. Changes in prevailing market rates of interest may therefore affect the Group's liquidity.

For the year ended 31 December 2006, the Group had interest and finance charges (net of interest income and amount capitalised) of HK$1,398 million. The weighted average interest rate on outstanding indebtedness (excluding obligations under finance leases) for 2006 was 5.5%, as compared to 4.7% and 5.1% in 2004 and 2005 respectively. For the six months ended 30 June 2007, the Group's weighted average interest rate on outstanding indebtedness (excluding obligations under finance leases) was 5.7% as compared to 5.0% and 5.5% for the corresponding periods in 2005 and 2006 respectively.

As at 30 June 2007, 67% of the Group's outstanding debt (excluding obligations under finance leases) bore interest at fixed rates or bore interest at floating rates, but was covered by interest rate swap agreements which fixed the interest cost to the Group. The remaining 33% of the Group's outstanding debt (excluding obligations under finance leases) bore interest at floating rates.

As at 30 June 2007, the Group had available undrawn committed and uncommitted credit facilities totaling HK$22.8 billion, including debt issuance programme, bank loans and other credit facilities.

Since 1 July 2007 to the Latest Practicable Date, there have been no significant changes to the weighted average interest rate in respect of the Group's outstanding indebtedness, the Group's mix of outstanding debt bearing interest at fixed and floating rates, nor the Group's total amount of available undrawn committed and uncommitted credit facilities.

## Cash flow

### For the six months ended 30 June 2006 and 2007

The Group's net cash inflow from railway and related activities increased to HK$2,981 million in the first half of 2007 compared to HK$2,728 million for the same period in 2006, while cash receipts from property development projects increased to HK$3,136 million from HK$584 million in the same period in 2006, mainly due to receipt of forward sale proceeds from Le Point at Tiu Keng Leng Station development. Total cash outflow before dividend and loan repayment decreased to HK$2,057 million as compared to HK$6,293 million in 2006 when an interest-free loan of HK$4,000 million was provided to the property developer of Tseung Kwan O Area 86 Package Two. Major outflows for the six months ended 30 June 2007 included capital project payments of HK$1,062 million, interest expenses of HK$791 million, investment in our associate Beijing MTR Corporation Limited of HK$103 million and other minor items. After the dividend payment of HK$777 million and net loan repayment of HK$3,176 million, there was net cash inflow of HK$107 million.

### For the years ended 31 December 2004, 2005 and 2006

Net cash inflow generated from operating activities increased to HK$5,400 million in 2006, compared to HK$5,189 million in 2005 and HK$4,486 million in 2004. The increase in 2006 was primarily due to increases in fare revenue, station commercial, rental and management income and other revenue as a result of business expansion, partly offset by an increase in total operating expenses in line with the expansion. The increase in 2005 was primarily due to an increase in operating profit from railway and related businesses before depreciation due to an increase in fare revenue, station commercial and other revenue and rental and management income, also partially offset by an increase in total operating expenses.

Net cash outflow from investing activities was HK$2,770 million in 2006 compared to HK$844 million in 2005 and HK$547 million in 2004. The increase in 2006 was mainly resulted from the interest-free loan provided to the property developer of package two of the Area 86 Tseung Kwan O development, partly offset by higher cash receipts from developers and purchasers in respect of various property development projects. The increase in 2005 over 2004 was mainly the result of the payment of the half of the land premium for package one of the Area 86 Tseung Kwan O development, increases in capital expenditures relating to other property development projects and the Tung Chung Cable Car project, and lower receipts from property developers, which was partially offset by a decrease in capital expenditures relating to the DRL project and the purchase of assets.

Net cash outflow from financing was HK$2,670 million in 2006 compared to HK$4,258 million in 2005 and HK$4,045 million in 2004. The reduction in 2006 compared to 2005 was primarily due to higher amount of loans drawn down to finance provision of the interest-free loan as well as the increased amount of loan repayment on matured debts. The increase in net cash outflow in 2005 compared to 2004 was mainly due to increases in dividend and interest payments.

## Capital Expenditures

The Group operates in a capital-intensive industry that requires a substantial amount of capital expenditure in connection with the construction of the railway lines. In addition, the Group continued to work on projects to improve passenger services and to enhance existing network with a view to maintaining growth in the local market.

In Tseung Kwan O Line, the Group continued to invest in the design and construction of the new Tseung Kwan O South Station at Area 86 at a currently estimated cost of approximately HK$1 billion. The project is scheduled for completion by the end of the first quarter of 2009 to meet the expected occupation date of the first property development package at Area 86.

In Airport Railway, the Group incurred capital expenditures of $459 million on West Rail Interface, Station Modification and Extended Overrun Tunnel Works for the three years from 2004 to 2006.

In 2004, the Group entered into an agreement with Hong Kong IEC Limited, a joint venture partially owned by the Government, for the design, construction, financing and operation of a new Airport Express station to serve the new AsiaWorld-Expo. The station was completed on schedule within the revised project budget at a cost to the Company of approximately HK$0.2 billion and commenced operations on 20 December 2005.

The Group's capital expenditure to expand its network include the construction of the DRL at a cost of HK$1.7 billion which was completed and officially opened for operations in August 2005 to provide a rail-shuttle service between the Tung Chung Line at a new station at Sunny Bay and the Hong Kong Disneyland theme park. In September 2006, the Tung Chung Cable Car project was completed at a cost of approximately HK$1.2 billion and is currently managed by a third-party contractor, Skyrail-ITM (Hong Kong) Limited.

In Urban Lines, additional capital expenditure on project works was incurred to continuously improve the connectivity to our stations, enhance passenger services and increase our operational efficiency.

Going forward, the Group expects to continue its capital expenditure to invest in new railway lines and extension network. The Group's actual and estimated capital expenditure between 2004 and 2009 are summarised in the following table:

| | **Incurred from 2004-2006** | **2007** | **2008-2009** | **Total** |
|---|---|---|---|---|
| | *(HK$ million)* | *(HK$ million)* | *(HK$ million)* | *(HK$ million)* |
| Tseung Kwan O Line Further Capital Works | 244 | 339 | 502 | 1,085 |
| Airport Railway Further Capital Works | 459 | 139 | 55 | 653 |
| Disney Resort Line, Tung Chung Cable Car and other projects | 2,411 | 325 | 11 | 2,747 |
| Urban Lines | 2,924 | 1,002 | 2,572 | 6,498 |

The Group expects to fund these expenditures through a mix of internally generated funds from railway and related businesses, property development profits and debt financing.

**Shareholders' Equity**

Share capital, share premium and capital reserve as at 30 June 2007 and 31 December 2006 were HK$39,421 million and HK$38,639 million respectively. The increase in 2007 was due to shares issued for scrip dividend and share options exercised. Together with increases in fixed asset revaluation and other reserves of HK$211 million and retained earnings net of dividends of HK$2,517 million, total equity attributable to equity shareholders increased to HK$80,277 million as at 30 June 2007 from HK$76,767 million as at 31 December 2006. As a result, the Group's gross debt-to-equity ratio improved from 36.7% at 2006 year-end to 31.4% at 30 June 2007.

## G. WORKING CAPITAL

The Directors are of the opinion that, taking into account the internal resources and the unutilised financing facilities currently available to the Group and new bank loan financing to be raised, the Group will, following completion of the proposed Rail Merger, have sufficient working capital to satisfy its present requirements for the twelve months following from the anticipated Merger Date.

*The following is the text of a report, prepared for the purpose of incorporation in this Circular received from the independent reporting accountants, KPMG, Certified Public Accountants, Hong Kong. As described in the paragraph headed "Documents Available for Inspection" in Appendix IX, a copy of the accountants' report on KCRC is available for inspection.*

KPMG

8th Floor
Prince's Building
10 Chater Road
Central
Hong Kong

3 September 2007

The Board of Directors
MTR Corporation Limited

Dear Sirs

**Introduction**

We set out below our report on the financial information relating to Kowloon-Canton Railway Corporation ("KCRC" or the "Corporation") and its subsidiaries (hereinafter collectively referred to as the "KCRC Group") including the consolidated income statements, the consolidated statements of changes in equity and the consolidated cash flow statements of the KCRC Group for each of the three years ended 31 December 2006 and the six months ended 30 June 2007 (the "Relevant Period") and the consolidated balance sheets of the KCRC Group and the balance sheets of KCRC as at 31 December 2004, 2005, 2006 and 30 June 2007, and a summary of significant accounting policies and the explanatory notes thereto, for inclusion in the circular issued by MTR Corporation Limited (the "Circular") in relation to the proposed Rail Merger between MTR Corporation Limited ("the Company") and KCRC ("proposed Rail Merger").

KCRC was incorporated in Hong Kong under the Kowloon-Canton Railway Corporation Ordinance ("the KCRC Ordinance") on 24 December 1982, as amended, to undertake the operation of the Hong Kong section of the Kowloon-Canton Railway, and which has subsequently been expanded to include the operation of the Light Rail System and any additional railway that the Secretary for the Environment, Transport, and Works (the Secretary for Transport at the time of the amendment, and now the Secretary for Transport and Housing) may authorise KCRC to construct.

**Basis of preparation**

Under the proposed Rail Merger as detailed elsewhere in this Circular, certain agreements are to be entered into (collectively referred to as "Transaction Documents") including:

- Service Concession Agreement ("SCA") in respect of the grant of the operating rights to access, use and operate the Hong Kong section of the Kowloon-Canton Railway ("railway network") for a specific term. Under the terms of the SCA, the Company is to pay an upfront lump sum upon signing the SCA plus an annual fixed payment for the duration of the term of the SCA. Additionally, commencing after three years from the date of the SCA, the Company is to pay a variable fee based on the railway receipts receivable from customers above a certain threshold which is payable on an annual basis.

- Property Package Agreements whereby property assets comprising certain investment and own-use properties, property management rights and property development rights currently held by the KCRC Group are to be acquired by the Company.

- Merger Framework Agreement in respect of the proposed framework for the Rail Merger.

For the purpose of this report, the directors of the Company consider that the inclusion of the published annual financial statements of the KCRC Group for the years ended 31 December 2004, 2005 and 2006 and the audited accounts for the six months ended 30 June 2007, which have been prepared by the directors of KCRC to give a true and fair view, would present the most meaningful information to the shareholders of the Company in understanding the business operations of the KCRC Group that will be subject to the terms of the proposed Rail Merger as specified in the Transaction Documents by presenting the revenue generated and expenses incurred together with the assets employed and liabilities incurred of the business operations of KCRC during the Relevant Period.

The Financial Information of KCRC Group for the Relevant Period, which comprises the consolidated income statement, the consolidated balance sheet, the Corporation balance sheet, the consolidated statement of changes in equity, the consolidated cash flow statement, and the explanatory notes (including the additional financial information of KCRC Group in respect of the effects of the proposed arrangement as set out in note 44) thereon, has been prepared in accordance with Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants (the "HKICPA").

**Respective responsibilities of directors and reporting accountants**

The Directors of the Company are responsible for the Financial Information set out in Sections A to B below which gives a true and fair view. In preparing the Financial Information which gives a true and fair view, it is fundamental that appropriate accounting policies are selected and applied consistently, that judgements and estimates are made which are prudent and reasonable and that the reasons for any significant departure from applicable accounting standards are stated.

It is our responsibility to form an independent opinion, based on our audit, on the Financial Information.

***Basis of opinion***

As a basis for forming an opinion on the Financial Information, for the purpose of this report, we have carried out appropriate audit procedures in respect of the Financial Information of the Relevant Period in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have carried out such additional procedures as we considered necessary in accordance with the Auditing Guideline 3.340 "Prospectuses and the reporting accountant" issued by the HKICPA.

An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Financial Information. It also includes an assessment of the significant estimates and judgements made by the directors of KCRC in the preparation of the Financial Information, and of whether the accounting policies are appropriate to the KCRC Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our work so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the Financial Information of the KCRC Group is free from material misstatement. In forming our opinion, we also evaluated the overall adequacy of the presentation of information in the Financial Information. We believe that our work provides a reasonable basis for our opinion.

We have not audited any financial statements of KCRC Group in respect of any period subsequent to 30 June 2007.

***Opinion***

In our opinion, for the purpose of this report, and on the basis of preparation set out above, the Financial Information of the KCRC Group comprising the consolidated income statements, the consolidated balance sheets, the Corporation balance sheets, the consolidated statements of changes in equity, the consolidated cash flow statements, and the explanatory notes thereon, gives a true and fair view of the state of affairs of the KCRC Group's consolidated results and cash flows for the Relevant Period and of the state of affairs of the KCRC Group and KCRC as at 31 December 2004, 2005, 2006 and 30 June 2007.

***Comparative Financial Information***

For the purpose of this report, the consolidated income statement, consolidated statement of changes in equity and consolidated statement of cash flows for the six months ended 30 June 2006, together with the notes thereon (the "30 June 2006 Corresponding Information"), for which the directors are responsible, has been reviewed in accordance with Hong Kong Standard on Review Engagements 2410, "Review of interim financial information performed by the independent auditor of the entity" issued by the HKICPA. A review consists principally of making enquiries of group management and applying analytical procedures to the 30 June 2006 Corresponding Information and based thereon, assessing whether the accounting policies and presentation have been consistently applied unless otherwise disclosed. A review excludes audit procedures such as tests of controls and verification of assets, liabilities and transactions. It is substantially less in scope than an audit and therefore provides a lower form of assurance than an audit. Accordingly we do not express an audit opinion on the 30 June 2006 Corresponding Information.

On the basis set out above, for the purpose of this report, we are not aware of any material modifications that should be made to the unaudited financial information presented for the six months ended 30 June 2006.

## A. ACCOUNTANTS' REPORT ON KCRC GROUP

### A1. Consolidated income statement

| *In HK$ million* | *Note* | Year ended 31 December 2006 | Year ended 31 December 2005 | Year ended 31 December 2004 | Six months ended 30 June 2007 | Six months ended 30 June 2006 *(unaudited)* |
|---|---|---|---|---|---|---|
| Turnover | 4 | 5,622 | 5,383 | 4,976 | 2,838 | 2,736 |
| Operating costs before depreciation and amortisation | 5 | (3,042) | (3,027) | (2,804) | (1,531) | (1,474) |
| **Operating profit before depreciation and amortisation** | 6 | 2,580 | 2,356 | 2,172 | 1,307 | 1,262 |
| Depreciation and amortisation | 7 | (2,288) | (2,258) | (1,681) | (1,153) | (1,137) |
| **Operating profit after depreciation and amortisation** | | 292 | 98 | 491 | 154 | 125 |
| Interest and finance income | 8(a) | 499 | 525 | 444 | 213 | 257 |
| Interest and finance expenses | 8(b) | (815) | (823) | (485) | (645) | (404) |
| Profit from property development | | 427 | — | — | — | — |
| Share of profit of associate | | 27 | 15 | 15 | 16 | 11 |
| **Profit/(loss) before unrealised gains/losses** | | 430 | (185) | 465 | (262) | (11) |
| Gains/(losses) on changes in fair value of derivative financial instruments and hedged borrowings | 9 | (198) | 400 | — | 283 | (112) |
| Net valuation gains on investment properties | 14 | 99 | 171 | 148 | 6 | 43 |
| **Profit/(loss) before taxation** | | 331 | 386 | 613 | 27 | (80) |
| Income tax | 10(a) | (53) | (69) | (100) | (8) | 20 |
| **Profit/(loss) for the year/period wholly attributable to the sole shareholder of the Corporation** | 11 | 278 | 317 | 513 | 19 | (60) |
| Dividend payable to the sole shareholder of the Corporation attributable to the year/period proposed after the balance sheet date | 12(a) | 82 | — | 172 | — | — |

### A2. Consolidated balance sheet

| | | As at 31 December | | | As at 30 June |
|---|---|---|---|---|---|
| *In HK$ million* | *Note* | **2006** | **2005** | **2004** | **2007** |
| **Assets** | | | | | |
| Fixed assets | 14 | | | | |
| — Property, plant and equipment | | 58,498 | 60,127 | 61,029 | 57,658 |
| — Investment properties | | 1,378 | 1,171 | 1,026 | 1,384 |
| | | 59,876 | 61,298 | 62,055 | 59,042 |
| Interest in leasehold land held for own use under operating leases | 14 | 5,524 | 5,645 | 5,691 | 5,471 |
| Construction in progress | 15 | 13,644 | 10,411 | 6,991 | 15,145 |
| Deferred expenditure | 16 | 1,389 | 1,210 | 1,462 | 1,490 |
| Properties under development | 17 | 449 | 1,537 | 1,892 | 457 |
| Interest in associate | 19 | 99 | 72 | 57 | 115 |
| Loans to third party | 20 | — | 684 | 733 | — |
| Loan to non-controlled subsidiary | 21 | 4,022 | 3,863 | 3,576 | 4,214 |
| Derivative financial assets | 33(e) | 92 | 129 | — | 70 |
| Investments | 22 | — | 449 | 4,323 | — |
| Stores and spares | 23 | 362 | 343 | 319 | 367 |
| Interest and other receivables | 24 | 571 | 717 | 756 | 463 |
| Cash and cash equivalents | 25 | 1,947 | 3,394 | 3,531 | 545 |
| | | 87,975 | 89,752 | 91,386 | 87,379 |
| **Liabilities** | | | | | |
| Short-term bank loans | 29 | — | — | — | 1,013 |
| Interest and other payables | 26 | 2,459 | 2,803 | 2,929 | 2,427 |
| Accrued charges and provisions for capital projects | 27 | 2,054 | 3,038 | 3,971 | 2,118 |
| Lease payable | 28 | — | 684 | 717 | — |
| Derivative financial liabilities | 33(e) | 540 | 361 | — | 293 |
| Interest-bearing borrowings | 29 | 19,212 | 19,474 | 19,748 | 17,839 |
| Deferred income | 30 | 527 | 541 | 708 | 562 |
| Deferred tax liabilities | 10(d) | 3,250 | 3,198 | 3,251 | 3,257 |
| | | 28,042 | 30,099 | 31,324 | 27,509 |
| **Net Assets** | | 59,933 | 59,653 | 60,062 | 59,870 |
| **Capital and Reserves** | | | | | |
| Share capital | 31 | 39,120 | 39,120 | 39,120 | 39,120 |
| Reserves | 32 | 20,813 | 20,533 | 20,942 | 20,750 |
| Total equity | | 59,933 | 59,653 | 60,062 | 59,870 |

**A3. Corporation balance sheet**

| *In HK$ million* | *Note* | At at 31 December 2006 | 2005 | 2004 | As at 30 June 2007 |
|---|---|---|---|---|---|
| **Assets** | | | | | |
| Fixed assets | 14 | | | | |
| — Property, plant and equipment | | 58,462 | 60,086 | 60,979 | 57,624 |
| — Investment properties | | 1,378 | 1,171 | 1,026 | 1,384 |
| | | 59,840 | 61,257 | 62,005 | 59,008 |
| Interest in leasehold land held for own use under operating leases | 14 | 5,524 | 5,645 | 5,691 | 5,471 |
| Construction in progress | 15 | 13,644 | 10,411 | 6,991 | 15,145 |
| Deferred expenditure | 16 | 1,389 | 1,210 | 1,462 | 1,490 |
| Properties under development | 17 | 449 | 1,537 | 1,892 | 457 |
| Interest in associate | 19 | 42 | 42 | 9 | 42 |
| Loans to third party | 20 | — | — | 16 | — |
| Loan to non-controlled subsidiary | 21 | 4,022 | 3,863 | 3,576 | 4,214 |
| Derivative financial assets | 33(e) | 92 | 129 | — | 70 |
| Investments | 22 | — | 449 | 4,323 | — |
| Stores and spares | 23 | 362 | 343 | 319 | 367 |
| Interest and other receivables | 24 | 578 | 707 | 751 | 472 |
| Cash and cash equivalents | 25 | 1,795 | 3,270 | 3,426 | 382 |
| | | 87,737 | 88,863 | 90,461 | 87,118 |
| **Liabilities** | | | | | |
| Short-term bank loans | 29 | — | — | — | 1,013 |
| Interest and other payables | 26 | 2,307 | 2,664 | 2,811 | 2,268 |
| Accrued charges and provisions for capital projects | 27 | 2,054 | 3,038 | 3,971 | 2,118 |
| Derivative financial liabilities | 33(e) | 540 | 361 | — | 293 |
| Interest-bearing borrowings | 29 | 19,212 | 19,474 | 19,748 | 17,839 |
| Deferred income | 30 | 492 | 501 | 663 | 529 |
| Deferred tax liabilities | 10(d) | 3,251 | 3,198 | 3,251 | 3,259 |
| | | 27,856 | 29,236 | 30,444 | 27,319 |
| **Net Assets** | | 59,881 | 59,627 | 60,017 | 59,799 |
| **Capital and Reserves** | | | | | |
| Share capital | 31 | 39,120 | 39,120 | 39,120 | 39,120 |
| Reserves | 32 | 20,761 | 20,507 | 20,897 | 20,679 |
| Total equity | | 59,881 | 59,627 | 60,017 | 59,799 |

**A4. Consolidated statement of changes in equity**

| *In HK$ million* | *Note* | Year ended 31 December 2006 | Year ended 31 December 2005 | Year ended 31 December 2004 | Six months ended 30 June 2007 | Six months ended 30 June 2006 (unaudited) |
|---|---|---|---|---|---|---|
| **Total equity at 1 January** | | 59,653 | 60,062 | 60,184 | 59,933 | 59,653 |
| Opening balance adjustments arising from changes in accounting policies under HKAS 32 and HKAS 39 | 32 | — | (568) | — | — | — |
| At 1 January, after opening balance adjustments | | 59,653 | 59,494 | 60,184 | 59,933 | 59,653 |
| **Net expenses for the year/period recognised directly in equity:** | | | | | | |
| Deficit on revaluation of available-for-sale securities | 32 | — | (15) | (54) | — | — |
| **Net profit/(loss) for the year/period** | 32 | 278 | 317 | 513 | 19 | (60) |
| Revaluation deficit transferred to the income statement on redemption and disposal of available-for-sale securities | 32 | 2 | 29 | 39 | — | 2 |
| Dividend approved and paid during the year/period | 12(b) | — | (172) | (620) | (82) | — |
| **Total equity at 31 December/30 June** | | 59,933 | 59,653 | 60,062 | 59,870 | 59,595 |

## A5. Consolidated cash flow statement

| | | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|---|
| *In HK$ million* | *Note* | **2006** | **2005** | **2004** | **2007** | **2006** *(unaudited)* |
| **Operating activities** | | | | | | |
| Net cash inflow from operations | 34 | 2,664 | 2,408 | 2,309 | 1,495 | 1,355 |
| Net cash inflow/(outflow) from property development | | 1,505 | 340 | (376) | (26) | 1,494 |
| Hong Kong profits tax paid | | (1) | (1) | (1) | (1) | — |
| **Net cash inflow from operating activities** | | 4,168 | 2,747 | 1,932 | 1,468 | 2,849 |
| **Investing activities** | | | | | | |
| Decrease/(increase) in deposits with banks with maturity more than three months when placed | | 1,084 | (615) | (740) | 259 | 423 |
| Payments for capital expenditure: | | | | | | |
| — East Rail Extensions project | | (2,038) | (2,821) | (4,534) | (379) | (1,025) |
| — Kowloon Southern Link project | | (1,344) | (709) | (105) | (875) | (637) |
| — other capital projects and purchase of fixed assets | | (1,140) | (1,459) | (2,345) | (408) | (403) |
| Interest received | | 237 | 750 | 1,358 | 30 | 121 |
| Dividend received from associate | | — | 33 | — | — | — |
| Repayment from/(loan to) non-controlled subsidiary | | 38 | (84) | (24) | (13) | (34) |
| Loan to associate | | — | (33) | — | — | — |
| Receipts on sales of fixed assets | | 5 | 4 | — | — | 4 |
| Receipts on redemption and disposal of available-for-sale securities | | 411 | 3,311 | 6,740 | — | 411 |
| **Net cash (outflow)/inflow from investing activities** | | (2,747) | (1,623) | 350 | (1,386) | (1,140) |
| **Net cash inflow before financing carried forward** | | 1,421 | 1,124 | 2,282 | 82 | 1,709 |

| In HK$ million | Note | Year ended 31 December 2006 | Year ended 31 December 2005 | Year ended 31 December 2004 | Six months ended 30 June 2007 | Six months ended 30 June 2006 (unaudited) |
|---|---|---|---|---|---|---|
| **Net cash inflow before financing brought forward** | | 1,421 | 1,124 | 2,282 | 82 | 1,709 |
| **Financing activities** | | | | | | |
| Net cash outflow on repayment of loans | | (298) | (279) | (273) | (392) | (148) |
| Dividend paid | | — | (172) | (620) | (82) | — |
| Interest paid | | (1,388) | (1,392) | (1,387) | (716) | (714) |
| Net cash inflow/(outflow) relating to derivative financial instruments | | (77) | (13) | 138 | (30) | (15) |
| Finance expenses paid | | (21) | (20) | (26) | (5) | (10) |
| **Net cash outflow from financing activities** | | (1,784) | (1,876) | (2,168) | (1,225) | (887) |
| **Net (decrease)/increase in cash and cash equivalents** | | (363) | (752) | 114 | (1,143) | 822 |
| **Cash and cash equivalents at 1 January** | | 1,839 | 2,591 | 2,477 | 1,476 | 1,839 |
| **Cash and cash equivalents at 31 December/30 June** | | 1,476 | 1,839 | 2,591 | 333 | 2,661 |
| **Analysis of the balances of cash and cash equivalents** | | | | | | |
| Cash at bank and in hand | 25 | 71 | 42 | 36 | 69 | 32 |
| Deposits with banks with maturity of less than three months when placed | 25 | 1,405 | 1,797 | 2,555 | 264 | 2,629 |
| | | 1,476 | 1,839 | 2,591 | 333 | 2,661 |

## B. NOTES TO THE FINANCIAL STATEMENTS

### 1 Establishment of the Corporation

The Kowloon-Canton Railway Corporation ("the Corporation") was incorporated in Hong Kong under the Kowloon-Canton Railway Corporation Ordinance ("the Ordinance") on 24 December 1982 to undertake the operation of the Hong Kong section of the Kowloon-Canton Railway. The assets, rights and liabilities of the then existing railway were vested in the Corporation on 1 February 1983 in accordance with Section 7 of the Ordinance.

The Ordinance was amended in 1986, 1998 and 2001. The amendment in 1986 enabled the Corporation to construct and operate the Light Rail system. The amendment in 1998 expanded the Corporation's power by permitting the Corporation to construct and operate any additional railway that the Secretary for the Environment, Transport and Works (the Secretary for Transport at the time of amendment, and now the Secretary for Transport and Housing) may authorise the Corporation to construct. The amendment in December 2001 provided for the separation of the functions and duties of the Chairman from those of the Chief Executive Officer by creating the office of Chief Executive Officer. The Chief Executive Officer was also appointed as a member of the Managing Board.

### 2 Significant accounting policies

***(a) Statement of compliance***

Although not required to do so under the Ordinance, the Corporation has prepared these financial statements in accordance with all applicable Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and accounting principles generally accepted in Hong Kong. These financial statements also comply with the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited and the Hong Kong Companies Ordinance. A summary of the significant accounting policies adopted by the Corporation and its controlled subsidiaries (the "KCRC Group") is set out below.

***(b) Basis of preparation of the financial statements***

The measurement basis used in the preparation of the financial statements is the historical cost basis except where stated otherwise in the accounting policies set out below.

The preparation of financial statements in conformity with HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets, liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the prevailing circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements with significant effect on the financial statements and estimates with significant risk of material adjustment are discussed in note 42.

The accounting policies set out below have been applied consistently to each year/period presented in these financial statements, except where the adoption of a new or revised accounting standard is not permitted to be applied retrospectively.

***(c) Basis of consolidation***

The consolidated financial statements comprise the Corporation and its controlled subsidiaries and the KCRC Group's interest in associate made up to 31 December or 30 June.

The financial statements of certain subsidiaries held by the Corporation for the sole purpose of developing, on behalf of the Government of the Hong Kong Special Administrative Region ("the Government"), commercial or residential properties along the West Rail, Phase I route are excluded from the consolidation on the basis that these are not considered to be controlled subsidiaries as the Corporation has no effective control over nor beneficial interests in the net assets of these subsidiaries, other than the amount of capital provided. The Corporation is not entitled to any earnings distribution, nor is it required to ultimately fund any losses which may be sustained by these subsidiaries.

***(d) Investments in subsidiaries***

Subsidiaries are entities controlled by the KCRC Group. Control exists when the KCRC Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable are taken into account.

An investment in a controlled subsidiary is consolidated into the consolidated financial statements from the date that control commences until the date that control ceases. An investment in a non-controlled subsidiary is excluded from consolidation and is stated at cost less impairment losses, if any, in the KCRC Group's and Corporation's balance sheets.

Intra-group balances and transactions and any unrealised profits arising from intra-group transactions with controlled subsidiaries are eliminated in full in preparing the consolidated financial statements. Unrealised losses resulting from intra-group transactions with controlled subsidiaries are eliminated in the same way as unrealised gains but only to the extent that there is no evidence of impairment.

In the Corporation's balance sheet, an investment in a subsidiary is stated at cost less impairment losses, if any.

***(e) Interest in associates***

An associate is an entity in which the KCRC Group or Corporation has significant influence, but not control or joint control, over its management, including participation in the financial and operating policy decisions.

An investment in an associate is accounted for in the KCRC Group's consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the KCRC Group's share of the associate's net assets. The consolidated income statement includes the KCRC Group's share of the post-acquisition and post-tax results of associates for the period.

Unrealised profits and losses resulting from transactions between the KCRC Group and its associates are eliminated to the extent of the KCRC Group's interest in the associate, except where unrealised losses provide evidence of an impairment of the asset transferred, in which case they are recognised immediately in the income statement.

The results of the associates are included in the Corporation's income statement to the extent of dividends received and receivable, providing the dividend in respect of a period ending on or before that of the Corporation and the Corporation's right to receive the dividend is established before the balance sheet date.

In the Corporation's balance sheet, an investment in an associate is stated at cost less impairment losses, if any.

***(f) Investments***

Investments comprise:

(i) temporary investment of funds from the equity injection received and borrowings obtained specifically for the construction of the East Rail Extensions and Kowloon Southern Link before the funds are used for such purposes ("pre-funding investments"); and

(ii) investment of surplus funds from the Corporation's operations ("other investments").

All the pre-funding investments and other investments are available-for-sale investments and are recognised initially at fair value at the date of recognition plus transaction costs. The fair value is remeasured at the balance sheet date, with any resultant gain or loss accounted for as follows:

(i) changes in fair value of pre-funding investments, together with all income generated from such investments, including interest income, exchange gains or losses, impairment losses, realised gains or losses arising from transactions in derivative financial instruments entered into for hedging foreign currency pre-funding investments and gains or losses arising from the derecognition of such investments, are capitalised to the related projects;

(ii) changes in fair value of other investments are recognised directly in the investments revaluation reserve, except for related impairment losses and foreign exchange gains and losses of monetary items such as debt securities, which are recognised directly in the income statement. Where these investments are interest-bearing, interest calculated using the effective interest method is recognised in the income statement. When these investments are derecognised, the cumulative gain or loss previously recognised directly in the investments revaluation reserve is recognised in the income statement.

Investments are recognised/derecognised on the trade date, which is the date the KCRC Group or the Corporation commits to purchase/sell the investments or when the investments expire.

***(g) Derivative financial assets and liabilities***

The KCRC Group uses derivative financial instruments to hedge its exposure to foreign exchange and interest rate risks arising from operational, financing and investment activities. In accordance with its policies, the KCRC Group does not hold or issue derivative financial instruments for trading purposes.

All the KCRC Group's derivative financial instruments are recognised initially as derivative financial assets or liabilities at fair value. The fair value of each of the derivative financial instruments is remeasured at each balance sheet date, with any resultant gain or loss recognised immediately in the income statement, except where the derivatives qualify for cash flow hedge accounting, in which case recognition of any resultant gain or loss depends on the item being hedged as covered by the policy statement below.

(i) *Cash flow hedges*

The currency swaps are designated as hedges of the variability in cash flows attributable to the foreign exchange risk of certain of the KCRC Group's interest-bearing borrowings denominated in foreign currencies and recognised in the financial statements.

Changes in fair value of currency swaps that hedge recognised monetary liabilities in foreign currencies are recognised in the income statement as required under HKAS 39.

(ii) *Fair value hedges*

The interest rate swaps are designated as hedges of the variability in the fair value attributable to interest rate risk of certain of the KCRC Group's fixed rate interest-bearing borrowings recognised in the financial statements.

Changes in fair value of interest rate swaps designated as hedging instruments in a fair value hedge are recognised in the income statement.

When a hedging relationship ceases to meet the requirements of hedge accounting, any adjustment to the carrying amount of the then hedged item is amortised to the income statement over the remaining life of the item based on a recalculated effective interest rate at the date amortisation begins.

***(h) Investment properties***

Investment properties comprise land and/or buildings which are owned or held under a leasehold interest to earn rental income and are held for their investment potential.

Investment properties are stated in the balance sheet at fair value. Any gain or loss arising from a change in fair value is recognised in the income statement.

Gains or losses arising from the retirement or disposal of an investment property are determined as the difference between the net disposal proceeds and the carrying amount of the item and are recognised in the income statement on the date of retirement or disposal.

***(i) Property, plant and equipment***

(i) Property, plant and equipment is stated in the balance sheet at cost less accumulated depreciation and impairment losses, if any.

Property, plant and equipment utilised in the operation of rail networks and ancillary commercial activities comprises:

— buildings held for own use which are situated on leasehold land, where the fair value of the building could be measured separately from the fair value of the leasehold land at the inception of the lease; and

— *other items of plant and equipment.*

The cost of property, plant and equipment vested by the Government has been determined as follows:

— for property, plant and equipment vested on 1 February 1983 - as determined by the Financial Secretary; and

— for property, plant and equipment vested subsequent to 1 February 1983 - based on actual cost as reflected in the Government's records.

The cost of property, plant and equipment acquired by the Corporation comprises:

— its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;

— any costs, such as the costs of material, direct labour, an appropriate proportion of production overheads and interest and finance income/expenses directly attributable to bringing the asset to the location and condition capable of operating in the manner intended by management; and

— the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, where the obligation is incurred by the KCRC Group when the item is acquired.

Expenditure on property, plant and equipment, which is below $20,000 per item or expected to be fully used within one year, is expensed to the income statement when incurred.

(ii) Subsequent expenditure on existing property, plant and equipment is added to the carrying amount of the asset if, either future economic benefits will flow to the KCRC Group or Corporation, or the condition of the asset will improve beyond its originally assessed standard of performance.

Expenditure on repairs or maintenance of existing property, plant and equipment to restore or maintain the originally assessed standard of performance of the asset is recognised as an expense when incurred.

(iii) Gains or losses arising from the retirement or disposal of an item of property, plant and equipment are determined as the difference between the net disposal proceeds and the carrying amount of the item and are recognised in the income statement on the date of retirement or disposal.

***(j) Depreciation***

(i) Depreciation is calculated to write off the cost of an item of property, plant and equipment less its estimated residual value, if any, using the straight-line basis over its estimated useful life as follows:

| | **No. of years** |
|---|---|
| Tunnels, bridges and roads (see note 2(j)(iii)) | 43-65 |
| Buildings (see note 2(j)(iii)) | 50 |
| Rolling stock | 30-40 |
| Locomotives and wagons | 15-35 |
| Lifts and escalators | 20 |
| Permanent way comprising rails, ballast, sleepers and concrete civil works (see note 2(j)(iii)) | 10-50 |
| Machinery and equipment | 10-30 |
| Telecommunication and signalling systems and air-conditioning plant | 5-15 |
| Fare collection systems | 15 |
| Mobile phone systems | 7-10 |
| Furniture and fixtures | 3-15 |
| Computer and office equipment (including computer software) | 3-5 |
| Buses | 10-17 |
| Other motor vehicles | 4-15 |

(ii) Where parts of an item of property, plant and equipment have different useful lives, the cost of the item is allocated on a measurable basis between the parts and each part is depreciated separately. Both the useful life of an asset and its residual value, if any, are reviewed annually. The residual value of an asset is the estimated amount that the Corporation would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset was already of the age and in the condition expected at the end of its useful life.

(iii) Tunnels, bridges, roads, concrete civil works and buildings situated on leasehold land are depreciated over the shorter of the unexpired term of the related lease and their estimated useful lives.

***(k) Leased assets***

(i) *Classification of leased assets*

Leases of assets under which the lessee assumes substantially all the risks and rewards of ownership are classified as finance leases. Leases of assets under which the lessor has not transferred substantially all the risks and rewards of ownership are classified as operating leases, except that property held under an operating lease that would otherwise meet the definition of an investment property may be classified as an investment property on a property-by-property basis.

(ii) *Assets leased out under operating leases*

Where the KCRC Group leases out assets under operating leases, the assets are included in the balance sheet according to their nature and, where applicable, are depreciated in accordance with the KCRC Group's depreciation policies.

(iii) *Operating lease charges*

Where the KCRC Group has the use of assets held under operating leases, payments made under the leases are charged to the income statement in equal instalments over the accounting periods covered by the lease term, except where an alternative basis is more representative of the pattern of benefits to be derived from the leased asset.

Land lease premiums, land resumption costs and other costs directly associated with the acquisition of leasehold land held for own use under operating leases are amortised on a straight-line basis over the period of the lease term. The cost in relation to leasehold land vested by the Government has been determined as follows:

— vested on 1 February 1983 - as determined by the Financial Secretary; and

— vested subsequent to 1 February 1983 - based on actual cost as reflected in the Government's records or the costs incurred by the Corporation directly associated with the acquisition of leasehold land.

***(l) Impairment of assets***

(i) *Impairment of financial assets*

All financial assets are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. Objective evidence of impairment includes observable data that comes to the attention of the KCRC Group about one or more of the following loss events:

— significant financial difficulties being experienced by a debtor;

— a breach of contract, such as a default or delinquency in interest or principal payments;

— it becomes probable that the debtor will enter bankruptcy or some form of financial reorganisation;

— significant changes in the technological, market, economic or legal environment that have an adverse effect on the debtor; and

— a significant or prolonged decline in the fair value of an investment in an equity instrument below its cost.

If any such evidence exists, an impairment loss is determined and recognised as follows:

— For interest and other receivables carried at cost, an impairment loss is measured as the difference between the asset's carrying amount and the estimated future cash flows (taking into account bad and doubtful debts), discounted at the current market rate of return of a similar financial asset where the effect of discounting is material. This assessment is made collectively where financial assets carried at amortised cost share similar risk characteristics, such as similar past due status, and have not been individually assessed as impaired. Future cash flows for financial assets which are assessed for impairment collectively are based on historical loss experience for assets with credit risk characteristics similar to the collective group.

— For loans to third party and loan to non-controlled subsidiary carried at amortised cost, an impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (taking into account bad and doubtful debts), discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at the date of initial recognition of these assets), except where the present value is not determinable as there are no fixed repayment terms.

— For investments, losses on revaluation are initially recognised directly in equity, or capitalised to the construction in progress or deferred expenditure where the losses are attributable to pre-funding investments relating to the equity injection received and borrowings obtained specifically for railway projects. If evidence of impairment exists, the cumulative loss that had been recognised directly in equity is removed from equity and is recognised in the income statement as an impairment loss. However, an impairment loss relating to the cumulative loss that had been capitalised to construction in progress or deferred expenditure is not transferred to the income statement. Any impairment loss recognised in subsequent years is accounted for as the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss previously recognised in the income statement and/or related cumulative loss capitalised to the construction in progress or deferred expenditure.

— Impairment losses are reversed if the subsequent increase in fair value can be objectively related to an event occurring after the impairment loss was recognised. Reversals of impairment losses in such circumstances are recognised in the income statement to the extent that the cumulative impairment loss has been charged to the income statement.

— Internal and external sources of information are reviewed at each balance sheet date to identify indications that the following assets may be impaired or an impairment loss previously recognised no longer exists or may have decreased:

  — property, plant and equipment;

  — interest in leasehold land held for own use under operating leases;

  — construction in progress;

  — deferred expenditure;

  — properties under development;

  — investments in subsidiaries; and

  — interest in associates.

If any such indication exists, the asset's recoverable amount is estimated.

— Calculation of recoverable amount

The recoverable amount of an asset is the greater of its net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of time value of money and the risks specific to the asset. Where an asset does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the smallest group of assets that generates cash inflows independently (i.e. a cash-generating unit).

— Recognition of impairment losses

An impairment loss is recognised in the income statement whenever the carrying amount of an asset, or the cash-generating unit to which it belongs, exceeds its recoverable amount. Impairment losses recognised in respect of cash-generating units are allocated to reduce the carrying amount of the other assets in the unit (or group of units) on a pro rata basis, except that the carrying value of an asset will not be reduced below its individual fair value less costs to sell, or value in use, if determinable.

— Reversals of impairment losses

An impairment loss is reversed if there has been a favourable change in the estimates used to determine the recoverable amount.

A reversal of an impairment loss is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years. Reversals of impairment losses are credited to the income statement in the period in which the reversals are recognised.

***(m) Construction in progress***

Assets under construction and capital works for the operating railways are stated at cost less impairment losses, if any. Costs comprise direct costs of construction, including materials, staff costs and overheads, interest and finance income/expenses and gain or loss arising from changes in fair value of pre-funding investments capitalised during the period of construction or installation and testing. Capitalisation of these costs is suspended or ceases when substantially all the activities necessary to prepare the qualifying asset for its intended use are interrupted or completed. The assets concerned are transferred to fixed assets when substantially all the activities necessary to prepare the assets for their intended use are completed, at which time the assets begin to be depreciated in accordance with the relevant policies. Land lease premiums, land resumption costs and other related costs incurred by the Corporation for the purpose of acquiring the land on which the new railways or extensions to existing railways are to be operated are initially included in construction in progress. These costs are transferred to interest in leasehold land held for own use under operating leases when the related assets are completed and ready for their intended use at which time the costs begin to be amortised in accordance with the relevant policies.

Costs incurred by the Corporation in respect of feasibility studies on proposed railway related construction projects (including consultancy fees, in-house staff costs and overheads) are dealt with as follows:

— where the proposed projects are at a preliminary review stage with no certainty of the proposed project proceeding, the costs concerned are written off to the income statement as incurred; and

— where the proposed projects are at a detailed study stage, having demonstrated an acceptable financial viability and having obtained the Managing Board's approval to proceed further, the costs concerned are initially dealt with as deferred expenditure and then transferred to construction in progress after the relevant project agreements are reached with the Government.

***(n) Deferred expenditure***

Deferred expenditure relates to costs incurred for proposed railway related construction projects which will be transferred to construction in progress after the relevant project agreements are reached with the Government.

***(o) Property development***

The Corporation is involved in a number of property development projects. When the Corporation determines or reaches agreement with property developers to develop a site for resale or for rent, the carrying amount of the leasehold land and existing buildings on the development site are transferred to properties under development. Costs related to the respective projects incurred by the Corporation are also dealt with as properties under development until such time that profit on the development is recognised by the Corporation.

Profits on property development undertaken in conjunction with property developers are recognised in the income statement as follows:

— where the Corporation receives payments from property developers as a consequence of their participation in a project to develop a property, such payments are set off against the balance in properties under development in respect of that project. Any surplus amounts of payments received from property developers in excess of the balance in properties under development are transferred to deferred income. In such circumstances, further costs subsequently incurred by the Corporation in respect of that project are charged against the related balance of deferred income and any excess is charged to properties under development to the extent it is considered to be recoverable. The balance of deferred income is credited to the income statement when the property enabling works are completed and acceptable for development, and after taking into account the outstanding risks and obligations in connection with the development, if any, retained by the Corporation. The balance of properties under development not previously offset by payments received from property developers is charged to the income statement where the costs are considered to be irrecoverable, together with provision for losses, if any, borne by the Corporation in respect of the development;

— where the Corporation receives a share of profits from the sale of properties, profits are recognised upon the issue of occupation permits provided the amounts of revenue and related costs can be measured reliably; and

— where the Corporation retains certain assets of the development, profits are measured based on the fair value of such assets and are recognised at the time of receipt after taking into account the costs incurred by the Corporation in respect of the development and the outstanding risks, if any, retained by the Corporation in connection with the development.

***(p) Jointly controlled operations***

Assets that the Corporation owns and the liabilities that it incurs for the purpose of jointly controlled operations are recognised in the balance sheet and classified according to the nature of the relevant item. The Corporation's share of revenue from the jointly controlled operations along with the expenses that it incurs are included in the income statement when it is probable that economic benefits associated with the transactions will flow to or from the Corporation, as applicable.

Jointly controlled operations include intercity train services to and from Hong Kong and Mainland China which are jointly provided by the Corporation and its Mainland China railway counterparts. The related revenue sharing arrangements are negotiated and agreed between the relevant parties on commercial terms with reference to the ratio of distance travelled within Hong Kong and Mainland China for each route. The term of the revenue sharing arrangements is not fixed but either party is entitled to terminate the operation with advance notice.

***(q) Loans to third party***

Loans to third party are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arose when the KCRC Group advanced funds directly to a third party pursuant to lease out and lease back transaction. There is no intention that such loans will be traded. Loans to third party are initially recognised at fair value and thereafter are stated at amortised cost using the effective interest method less impairment losses, if any.

***(r) Loan to non-controlled subsidiary***

Loan to non-controlled subsidiary is a non-derivative financial asset without fixed or determinable repayment terms and is not quoted in an active market. It arose when the KCRC Group entered into a shareholding agreement with the Government for the formation of a sub-group of the Corporation under an intermediate holding company, West Rail Property Development Limited ("WRPDL"), to undertake all property developments along the West Rail, Phase I route. Loan to non-controlled subsidiary is initially recognised at fair value, which is equivalent to cost, and thereafter is stated at cost less impairment losses, if any.

***(s) Stores and spares***

Stores and spares are valued at cost of purchase on a weighted average basis. Obsolete stores and spares are written off to the income statement. When stores and spares are consumed, the carrying amount of those stores and spares is recognised as an expense in the period in which the consumption occurs.

***(t) Cash and cash equivalents***

Cash and cash equivalents comprise cash at bank and on hand, demand deposits with banks and other financial institutions and short-term, highly liquid investments. Cash equivalents are readily convertible into known amounts of cash with an insignificant risk of changes in value and have a maturity of less than three months at acquisition.

For the purposes of the consolidated cash flow statement, cash equivalents would exclude bank deposits with a maturity of more than three months when placed but include bank overdrafts that are repayable on demand and form an integral part of the KCRC Group's cash management.

***(u) Interest and other receivables***

Interest and other receivables are initially recognised at fair value and thereafter are stated at amortised cost less impairment losses, if any, except where the present value is not determinable because there is no fixed repayment term. In such cases, interest and other receivables are stated at cost less impairment losses, if any.

***(v) Interest-bearing borrowings***

Interest-bearing borrowings are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, the unhedged portion of interest-bearing borrowings is stated at amortised cost with any difference between the cost and redemption value being recognised in the income statement over the period of the borrowings using the effective interest method.

Subsequent to initial recognition, the carrying amount of the portion of interest-bearing borrowings, which is the subject of a fair value hedge, is remeasured and the change in fair value attributable to the risk being hedged is recognised in the income statement to offset the effect of the gain or loss on the related hedging instrument.

***(w) Lease payable***

Lease payable arising from a lease out and lease back transaction is initially recognised at fair value and thereafter is stated at amortised cost using the effective interest method.

***(x) Interest and other payables***

Interest and other payables are initially recognised at fair value and thereafter are stated at amortised cost except where the present value is not determinable because there are no fixed payment terms. In such cases, other payables are stated at cost.

***(y) Employee benefits***

(i) *Short term employee benefits and contributions to defined contribution retirement plans*

Salaries, annual bonuses, paid annual leave, contributions to defined contribution retirement plans and the cost of non-monetary benefits are accrued in the period in which the associated services are rendered by employees.

(ii) *Termination benefits*

Termination benefits are recognised when, and only when, the KCRC Group demonstrably commits itself to terminate employment or to provide benefits as a result of voluntary redundancy by having a detailed formal plan which is without realistic possibility of withdrawal.

***(z) Income tax***

(i) Income tax for the year/period comprises current tax and movements in deferred tax assets and liabilities. Current tax and movements in deferred tax assets and liabilities are recognised in the income statement except to the extent that they relate to items recognised directly to equity, in which case they are recognised in equity.

(ii) Current tax is the expected tax payable on the taxable income for the period, using tax rates enacted or substantively enacted at the balance sheet date and any adjustment to tax payable in respect of previous periods.

(iii) Deferred tax assets and liabilities arise from deductible and taxable temporary differences respectively, being the differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts for tax purposes. Deferred tax assets also arise from unused tax losses and unused tax credits.

All deferred tax assets, to the extent that it is probable that future taxable profits will be available against which the assets can be utilised, are recognised. All deferred tax liabilities are recognised.

The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of the assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date. Deferred tax assets and liabilities are not discounted.

The carrying amount of a deferred tax asset is reviewed at each balance sheet date and is reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow the related tax benefit to be utilised. Such reduction is reversed to the extent that it becomes probable that sufficient taxable profits will be available.

(iv) Current tax balances and deferred tax balances, and movements therein, are presented separately from each other and are not offset. Current tax assets are offset against current tax liabilities, and deferred tax assets against deferred tax liabilities if the KCRC Group or Corporation has the legally enforceable right to set off current tax assets against current tax liabilities and the following additional conditions are met:

— in the case of current tax assets and liabilities, the KCRC Group or Corporation intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously; or

— in the case of deferred tax assets and liabilities, they relate to income taxes levied by the same taxation authority on either:

  — the same taxable entity; or

  — different taxable entities which intend to realise the current tax assets and settle the current tax liabilities on a net basis in the same period.

***(aa) Provisions and contingent liabilities***

Provisions are recognised for liabilities of uncertain timing or amount when the KCRC Group or the Corporation has a legal or constructive obligation arising as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made. Where the time value of money is material, provisions are stated at the present value of the expenditure expected to settle the obligation.

Where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably, the possibility of an obligation arising as a result of a past event is disclosed as a contingent liability, unless the probability of outflow of economic benefits is remote. Possible obligations, whose existence will only be confirmed by the occurrence or non-occurrence of one or more future events are also disclosed as contingent liabilities unless the probability of outflow of economic benefits is remote.

***(ab) Revenue recognition***

Provided it is probable that the economic benefits will flow to the KCRC Group and the revenue and costs, if applicable, can be measured reliably, revenue is recognised in the income statement as follows:

(i) *Passenger and freight services*

Revenue is recognised when the services are provided.

(ii) *Rental and licence income*

Rental and licence income receivable under operating leases is recognised in the income statement in equal instalments over the periods covered by the lease term, except where an alternative basis is more representative of the pattern of benefits to be derived from the use of the leased asset. Lease incentives granted are recognised in the income statement as an integral part of the aggregate net lease payment receivable. Contingent rentals are recognised as income in the accounting period in which they are earned.

(iii) *Interest income*

Interest income is recognised as it accrues using the effective interest method.

(iv) *Other income*

Other income is recognised once the related services or goods are delivered and the related risks and rewards of ownership have been transferred.

***(ac) Lease out and lease back transactions***

A series of lease out and lease back transactions with third parties is linked and accounted for as one arrangement when the overall economic effect cannot be understood without reference to the series of transactions as a whole and when the series of transactions is closely interrelated, negotiated as a single arrangement and takes place concurrently or in a continued sequence.

The primary purpose of such arrangements is to achieve a particular tax result for the third parties in return for a fee. The arrangements do not, in substance, involve a lease under HKAS 17 since the KCRC Group retains all the risks and rewards incidental to the ownership of the underlying assets and enjoys substantially the same rights to their use as before the transactions were entered into. The transactions are, therefore, not accounted for as leases.

Where commitments to make long-term lease payments have been defeased by the placement of security deposits or by the advance of loans to third party, they are not recognised in the balance sheet. Where commitments and deposits or advances of loans to third party meet the definition of a liability and an asset, they are recognised in the balance sheet.

The income and expenses arising from the arrangements are accounted for on a net basis in order to reflect the overall commercial effect of the transactions. The net amounts are accounted for as deferred income and are amortised over the applicable lease terms of the transactions.

***(ad) Translation of foreign currencies***

Foreign currency transactions during the year/period are translated into Hong Kong dollars at the exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the foreign exchange rates ruling at the balance sheet date.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the foreign exchange rates ruling at the transaction dates. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated into Hong Kong dollars using the foreign exchange rates ruling at the dates the fair value was determined.

***(ae) Interest and finance income/expenses***

(i) Interest and finance income includes:

— interest income from bank deposits, investments and loans to other parties;

— realised gains arising from derivative financial instruments designated as hedges for borrowings;

— net gains on redemption and disposal of investments; and

— net exchange gains arising from foreign currency transactions.

(ii) The KCRC Group's interest and finance income arising from non-derivative financial assets are not classified as at fair value through the income statement.

Interest and finance income is credited to the income statement in the period in which it is earned, except for the portion generated from pre-funding investments which is credited to construction in progress or deferred expenditure, as appropriate.

(iii) Interest and finance expenses include:

— interest payable on borrowings and lease payable;

— finance expenses including amortisation of discounts/premiums and ancillary costs incurred in connection with the arrangement of borrowings calculated using the effective interest rate;

— realised losses arising from derivative financial instruments designated as hedges for borrowings;

— net realised losses on redemption and disposal of investments; and

— net exchange losses arising from foreign currency transactions.

(iv) The KCRC Group's interest and finance expenses arising from non-derivative financial liabilities are not classified as at fair value through the income statement.

Interest and finance expenses are expensed in the income statement in the period in which they are incurred, except to the extent that they are capitalised as being directly attributable to the acquisition, construction or production of an asset which necessarily takes a substantial period of time to get ready for its intended use or sale.

***(af) Related parties***

For the purposes of these financial statements, parties are considered to be related to the KCRC Group if the KCRC Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the KCRC Group and the party are subject to common control or common significant influence. Related parties may be individuals (being members of key management personnel and/or their close family members) or other entities and include entities which are under the significant influence of related parties of the KCRC Group where those parties are individuals.

***(ag) Segment reporting***

A segment is a distinguishable component of the KCRC Group that is engaged either in providing products or services (business segment), or in providing products or services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other segments.

Business segment information is the primary reporting format in accordance with the KCRC Group's internal financial reporting. Segment revenue, expenses, results, assets and liabilities include items directly attributable to a segment as well as those that are allocated from other segments on a cost recovery basis.

Segment capital expenditure is the total cost incurred during the year to acquire segment assets.

Unallocated items mainly comprise financial and corporate assets, interest-bearing loans, borrowings, tax balances, corporate and financing expenses.

## 3 Changes in accounting policies

The HKICPA has issued a number of new and revised HKFRSs and Interpretations that are first effective for the current accounting period commencing 1 January 2007 or available for early adoption.

There have been no significant changes to the accounting policies applied in these financial statements for the periods presented as a result of these developments. However, as a result of the adoption of HKFRS 7, Financial instruments: Disclosures and the amendments to HKAS 1, Presentation of financial statements: Capital disclosures, these financial statements include certain additional disclosures which are explained as follows.

As a result of the adoption of HKFRS 7, the financial statements include expanded disclosure about the significance of the KCRC Group's financial instruments and the nature and extent of risks arising from those instruments, compared with the information previously required to be disclosed by HKAS 32, Financial instruments: Disclosure and presentation. These disclosures are provided throughout these financial statements, in particular in note 33.

The amendment to HKAS 1 introduces additional disclosure requirements to provide information about the level of capital and the KCRC Group's and the Corporation's objectives, policies and processes for managing capital. These new disclosures are set out in note 31.

Both HKFRS 7 and the amendments to HKAS 1 do not have any impact on the classification, recognition and measurement of the amounts recognised in the financial statements.

The KCRC Group has not applied any new standard or interpretation that is not yet effective for the current accounting period (see note 43).

## 4 Turnover

Turnover represents the revenue from passenger, freight and property services after eliminating inter-company transactions. The amounts of revenue recognised in turnover classified by principal activity during the year/period are as follows:

| | **Year ended 31 December** | | | **Six months ended 30 June** | |
|---|---|---|---|---|---|
| *In HK$ million* | **2006** | **2005** | **2004** | **2007** | **2006** |
| | | | | | *(unaudited)* |
| Transport services | | | | | |
| Passenger services | | | | | |
| — East Rail | 3,780 | 3,670 | 3,415 | 1,883 | 1,841 |
| — West Rail and Light Rail | 922 | 890 | 798 | 463 | 448 |
| Freight services | 44 | 52 | 68 | 21 | 21 |
| | 4,746 | 4,612 | 4,281 | 2,367 | 2,310 |
| Property services | 876 | 771 | 695 | 471 | 426 |
| | 5,622 | 5,383 | 4,976 | 2,838 | 2,736 |

**5 Operating costs before depreciation and amortisation**

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| *In HK$ million* | **2006** | **2005** | **2004** | **2007** | **2006** |
| | | | | | *(unaudited)* |
| Staff costs | | | | | |
| — Gross amount* | 2,092 | 2,068 | 2,154 | 1,050 | 1,042 |
| — Staff costs capitalised | (549) | (547) | (692) | (261) | (273) |
| | 1,543 | 1,521 | 1,462 | 789 | 769 |
| Electricity and fuel | 484 | 495 | 456 | 236 | 224 |
| Repairs and maintenance | 274 | 265 | 180 | 120 | 133 |
| Stores and spares consumed | 217 | 181 | 158 | 106 | 107 |
| General supplies | 31 | 33 | 32 | 12 | 13 |
| Government rent and rates | 78 | 82 | 68 | 43 | 40 |
| Octopus cards usage fees | 38 | 36 | 33 | 19 | 19 |
| Cost of services acquired | 148 | 150 | 144 | 69 | 71 |
| Property ownership and management expenses | 66 | 84 | 63 | 25 | 31 |
| Expenses to prepare for the proposed merger with MTR Corporation Limited ("MTRCL")# | 20 | — | — | 36 | 1 |
| Others | 143 | 180 | 208 | 76 | 66 |
| | 3,042 | 3,027 | 2,804 | 1,531 | 1,474 |

* Includes retirement costs of $136 million, $135 million, $138 million, $68 million and $65 million (unaudited) after a forfeiture of unvested contributions of $1 million, $2 million, $3 million, $1 million and $1 million (unaudited) for the years ended 31 December 2006, 2005, 2004 and for the six months ended 30 June 2007 and 2006 respectively.

\# Includes staff costs of $2 million, nil, nil , $3 million and nil (unaudited) for the years ended 31 December 2006, 2005, 2004 and for the six months ended 30 June 2007 and 2006, respectively.

**6 Operating profit before depreciation and amortisation**

(a) Operating profit before depreciation and amortisation is arrived at after charging:

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| *In HK$ million* | **2006** | **2005** | **2004** | **2007** | **2006** *(unaudited)* |
| Fixed assets written off on disposal | 24 | 43 | 24 | 19 | 11 |
| Auditors' remuneration | | | | | |
| — Audit services | 4 | 4 | 4 | 5 | 2 |
| — Tax compliance services | — | 1 | 1 | — | — |
| — Other professional services | 1 | 4 | — | 2 | — |
| Operating lease charges (minimum lease payments) | | | | | |
| — Hire of plant and machinery | 28 | 28 | 29 | 14 | 14 |
| — Rental of property | 9 | 8 | 13 | 5 | 5 |
| Remuneration of Members of the Managing Board and Executive Directors who are not Members of the Managing Board | | | | | |
| — Fees for Members of the Managing Board including the Chairman but excluding the Chief Executive Officer | 1 | 1 | 1 | 1 | 1 |
| — Contributions to retirement benefit schemes for the Chief Executive Officer and Executive Directors who are not Members of the Managing Board | 1 | 1 | 1 | 1 | 1 |
| — Emoluments of the Chief Executive Officer and Executive Directors who are not Members of the Managing Board | 26 | 25 | 34 | 12 | 14 |
| and after crediting: | | | | | |
| Rentals receivable from operating leases* | 756 | 642 | 551 | 393 | 369 |
| Rentals receivable from investment properties# | 75 | 38 | 62 | 45 | 35 |

* Excludes direct outgoings of $20 million, $16 million, $17 million, $10 million and $11 million (unaudited), including contingent rentals of $63 million, $39 million, $29 million, $36 million and $27 million (unaudited) for the years ended 31 December 2006, 2005 and 2004 and for the six months ended 30 June 2007 and 2006, respectively.

# Excludes direct outgoings of $11 million, $14 million, $18 million, $4 million and $4 million (unaudited) for the years ended 31 December 2006, 2005 and 2004 and for the six months ended 30 June 2007 and 2006, respectively.

(b) Fees for Members of the Managing Board including the Chairman but excluding the Chief Executive Officer are shown below:

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| *In HK$ million* | **2006** | **2005** | **2004** | **2007** | **2006** |
| | | | | | *(unaudited)* |
| **Chairman** | | | | | |
| Mr Michael P S Tien | 220 | 220 | 220 | 110 | 110 |
| **Members** | | | | | |
| Mr Vincent H C Cheng * | — | — | 96 | — | — |
| Dr Sarah S T Liao in the capacity of Secretary for the Environment, Transport and Works | 110 | 110 | 110 | 55 | 55 |
| Mr Vincent W S Lo | 110 | 110 | 110 | 55 | 55 |
| Mr Frederick S H Ma in the capacity of Secretary for Financial Services and the Treasury | 110 | 110 | 110 | 55 | 55 |
| Mr L S Ng ** | 110 | 110 | 14 | 55 | 55 |
| Mr Patrick B Paul | 110 | 110 | 110 | 55 | 55 |
| The Honourable Abraham L H Shek *** | 110 | 110 | 101 | 55 | 55 |
| Mr Victor H W So # | — | — | 9 | — | — |
| Mr M Y Wan | 110 | 110 | 110 | 55 | 55 |
| Mr Patrick S C Wang ## | — | — | 9 | — | — |
| Professor Richard Y C Wong ### | 110 | 110 | 101 | 55 | 55 |
| | 1,100 | 1,100 | 1,100 | 550 | 550 |

* Mr Vincent H C Cheng resigned on 15 November 2004.

** Mr L S Ng was appointed on 16 November 2004.

*** The Honourable Abraham L H Shek was appointed on 1 February 2004.

# Mr Victor H W So resigned on 31 January 2004.

## Mr Patrick S C Wang resigned on 31 January 2004.

### Professor Richard Y C Wong was appointed on 1 February 2004.

(c) Emoluments of the Chief Executive Officer and Executive Directors who are not Members of the Managing Board include fixed remuneration which comprises base pay, allowances and gratuities; benefits-in-kind; retirement benefit scheme contributions and variable remuneration. Variable remuneration is paid based on the overall performance of the Corporation and the individual concerned measured against the pre-defined threshold target approved by the Managing Board. Details of emoluments are shown below:

| | **Year ended 31 December 2006 $ million** | | | |
|---|---|---|---|---|
| | **Fixed remuneration and benefits-in-kind** | **Contribution to retirement benefit scheme** | **Variable remuneration** | **Total** |
| Mr James Blake ## (Chief Executive Officer) | 3.00 | — | 1.19 | 4.19 |
| Mr Samuel M H Lai *** (Acting Chief Executive Officer) | 3.04 | 0.13 | — | 3.17 |
| Mr K K Lee (Senior Director-Capital Projects) | 3.12 | 0.32 | 0.91 | 4.35 |
| Mr Y T Li (Senior Director-Transport) | 3.22 | 0.29 | 0.81 | 4.32 |
| Mr Daniel C Lam (Director-Property) | 3.24 | 0.01 | 0.92 | 4.17 |
| Mr Lawrence C P Li (Director-Finance) | 2.28 | 0.22 | 0.44 | 2.94 |
| Mrs Mimi Cunningham (Director-Human Resource) | 3.18 | 0.01 | 0.86 | 4.05 |
| | 21.08 | 0.98 | 5.13 | 27.19 |

## Mr James Blake joined the Corporation on 22 March 2006.

*** Mr Samuel M H Lai's remuneration includes an end-of-service payment of $1.1 million. He left the Corporation on 1 May 2006.

| | Year ended 31 December 2005 $ million | | | |
|---|---|---|---|---|
| | Fixed remuneration and benefits-in-kind | Contribution to retirement benefit scheme | Variable remuneration | Total |
| Mr Samuel M H Lai (Acting Chief Executive Officer) | 3.58 | 0.38 | 0.95 | 4.91 |
| Mr K K Lee (Senior Director-Capital Projects) | 3.05 | 0.32 | 0.79 | 4.16 |
| Mr Y T Li (Senior Director-Transport) | 3.11 | 0.28 | 0.71 | 4.10 |
| Mr Ian M Thoms @@@ (Director-West Rail) | 1.96 | 0.01 | — | 1.97 |
| Mr Daniel C Lam (Director-Property) | 3.25 | 0.01 | 0.82 | 4.08 |
| Mr Lawrence C P Li ** (Director-Finance) | 2.18 | 0.21 | 0.39 | 2.78 |
| Mrs Mimi Cunningham (Director-Human Resource) | 3.03 | 0.01 | 0.76 | 3.80 |
| | 20.16 | 1.22 | 4.42 | 25.80 |

@@@ Mr Ian M Thoms retired on 1 July 2005.

** With effect from 1 January 2005, a portion of total remuneration was converted to variable remuneration related to performance.

| | Year ended 31 December 2004 $ million | | | |
|---|---|---|---|---|
| | Fixed remuneration and benefits-in-kind | Contribution to retirement benefit scheme | Variable remuneration | Total |
| Mr Samuel M H Lai * (Acting Chief Executive Officer) | 4.51 | 0.38 | 0.51 | 5.40 |
| Mr K K Lee * (Senior Director-Capital Projects) | 3.52 | 0.31 | 0.40 | 4.23 |
| Mr Y T Li * (Senior Director-Transport) | 3.63 | 0.28 | 0.37 | 4.28 |
| Mr Ian M Thoms (Director-West Rail) | 3.48 | 0.01 | 0.39 | 3.88 |
| Mr Daniel C Lam * (Director-Property) | 3.71 | 0.01 | 0.41 | 4.13 |
| Mr Lawrence C P Li (Director-Finance) | 2.59 | 0.21 | — | 2.80 |
| Mrs Mimi Cunningham *@ (Director-Human Resource) | 2.17 | 0.01 | 0.38 | 2.56 |
| Mr Jonathan H G Yu # (Director-Operations) | 5.81 | 0.31 | — | 6.12 |
| Mr Kenneth K S Leung @@ (Director-New Railway Projects) | 2.03 | — | — | 2.03 |
| | 31.45 | 1.52 | 2.46 | 35.43 |

* With effect from 1 July 2004, a portion of total remuneration was converted to variable remuneration related to performance. Variable remuneration mainly comprises amounts withheld from employees' basic salary packages and released for payment upon their satisfactory performance being confirmed by the Managing Board. The total variable remuneration is calculated according to a formula approved by the Managing Board.

\# Mr Jonathan H G Yu's remuneration includes a contractual payment totalling $1.2 million and an end-of-service payment of $0.9 million. He left the Corporation on 3 January 2005.

@ Mrs Mimi Cunningham assumed her post with effect from May 2004.

@@ Mr Kenneth K S Leung retired on 1 July 2004.

| | Six months ended 30 June 2007 $ million | | | |
|---|---|---|---|---|
| | Fixed remuneration and benefits-in-kind | Contribution to retirement benefit scheme | Variable remuneration | Total |
| Mr James Blake (Chief Executive Officer) | 1.80 | — | 0.78 | 2.58 |
| Mr K K Lee (Senior Director-Capital Projects) | 1.54 | 0.16 | 0.41 | 2.11 |
| Mr Y T Li (Senior Director-Transport) | 1.77 | 0.15 | 0.37 | 2.29 |
| Mr Daniel C Lam (Director-Property) | 1.77 | 0.01 | 0.42 | 2.20 |
| Mr Lawrence C P Li (Director-Finance) | 1.24 | 0.11 | 0.20 | 1.55 |
| Mrs Mimi Cunningham (Director-Human Resource) | 1.59 | 0.01 | 0.39 | 1.99 |
| | 9.71 | 0.44 | 2.57 | 12.72 |

| | Six months ended 30 June 2006 $ million (unaudited) | | | |
|---|---|---|---|---|
| | Fixed remuneration and benefits-in-kind | Contribution to retirement benefit scheme | Variable remuneration | Total |
| Mr James Blake (Chief Executive Officer) | 1.13 | — | 0.26 | 1.39 |
| Mr Samuel M H Lai (Acting Chief Executive Officer) | 3.04 | 0.13 | — | 3.17 |
| Mr K K Lee (Senior Director-Capital Projects) | 1.65 | 0.16 | 0.39 | 2.20 |
| Mr Y T Li (Senior Director-Transport) | 1.78 | 0.14 | 0.36 | 2.28 |
| Mr Daniel C Lam (Director-Property) | 1.78 | 0.01 | 0.41 | 2.20 |
| Mr Lawrence C P Li (Director-Finance) | 1.13 | 0.10 | 0.20 | 1.43 |
| Mrs Mimi Cunningham (Director-Human Resource) | 1.54 | 0.01 | 0.38 | 1.93 |
| | 12.05 | 0.55 | 2.00 | 14.60 |

The above includes the remuneration of the five highest paid employees of the Corporation.

## 7 Depreciation and amortisation

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2007 | 2006 |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| | | | | | *(unaudited)* |
| Depreciation: | | | | | |
| — assets leased out under operating leases | 32 | 32 | 16 | 16 | 17 |
| — other assets | 2,141 | 2,111 | 1,559 | 1,079 | 1,061 |
| — depreciation charge capitalised | (4) | (3) | (6) | (2) | (1) |
| | 2,169 | 2,140 | 1,569 | 1,093 | 1,077 |
| Amortisation: | | | | | |
| — amortisation of interest of leasehold land held for own use under operating leases | 119 | 118 | 112 | 60 | 60 |
| | 2,288 | 2,258 | 1,681 | 1,153 | 1,137 |

## 8 Interest and finance income/expenses

### *(a) Interest and finance income*

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2007 | 2006 |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| | | | | | *(unaudited)* |
| Interest income from deposits | 143 | 128 | 48 | 23 | 76 |
| Interest income from investments | 4 | 60 | 166 | — | 4 |
| Interest income from loans to third party | — | 51 | 53 | — | — |
| Interest income from loan to non-controlled subsidiary | 320 | 266 | 241 | 176 | 157 |
| Interest income from non-derivative financial assets | 467 | 505 | 508 | 199 | 237 |
| Realised gains arising from derivative financial instruments | 32 | 85 | 197 | 14 | 20 |
| Exchange gains (net) | — | 33 | 15 | — | — |
| | 499 | 623 | 720 | 213 | 257 |
| Less: Amount capitalised * | — | (98) | (276) | — | — |
| | 499 | 525 | 444 | 213 | 257 |

* Interest income capitalised for 2005 and 2004 was earned at average interest rates ranging between 1.37% and 2.54%, and 2.26% and 4.20% per annum, respectively.

*(b) Interest and finance expenses*

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** | **2006** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million (unaudited)* |
| Interest expenses on lease payable | — | 50 | 52 | — | — |
| Interest expenses on other loans | 1,407 | 1,394 | 1,384 | 706 | 698 |
| Finance expenses | 9 | 18 | 20 | 5 | 4 |
| Interest and finance expenses on non-derivative financial liabilities | 1,416 | 1,462 | 1,456 | 711 | 702 |
| Realised losses arising from derivative financial instruments | 126 | 106 | 102 | 61 | 64 |
| Exchange loss (net) | 40 | — | — | 86 | 11 |
| Realised losses on redemption and disposal of investments* | 3 | 35 | 67 | — | 3 |
| | 1,585 | 1,603 | 1,625 | 858 | 780 |
| Less: Amount capitalised # | (770) | (780) | (1,140) | (213) | (376) |
| | 815 | 823 | 485 | 645 | 404 |

* Includes $2 million, $29 million, $39 million, nil and $2 million (unaudited) for the years ended 31 December 2006, 2005 and 2004 and for the six months ended 30 June 2007 and 2006, respectively, transferred from the investments revaluation reserve.

\# Interest expenses capitalised were charged at average interest rates ranging between 7.10% and 7.98%, 6.83% and 7.54%, 6.02% and 6.88%, 7.69% and 7.91% and 7.10% and 7.88% (unaudited) per annum for the years ended 31 December 2006, 2005 and 2004 and for the six months ended 30 June 2007 and 2006, respectively.

**9 Gains/(losses) on changes in fair value of derivative financial instruments and hedged borrowings**

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** | **2006** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million (unaudited)* |
| Net gain/(loss) arising from derivative financial instruments # | (216) | 227 | — | 225 | (186) |
| Net gain arising from hedged interest-bearing borrowings * | 18 | 173 | — | 58 | 74 |
| | (198) | 400 | — | 283 | (112) |

\# Includes losses arising from the revaluation of effective fair value hedges of $8 million, $183 million, nil (not applicable), $41 million and $60 million (unaudited) for the years ended 31 December 2006, 2005 and 2004 and the six months ended 30 June 2007 and 2006, respectively.

* Includes gains arising from the revaluation of effective fair value hedges of $9 million, $173 million, nil (not applicable), $41 million and $60 million (unaudited) for the years ended 31 December 2006, 2005 and 2004 and the six months ended 30 June 2007 and 2006, respectively.

**10 Income tax**

(a) Income tax in the consolidated income statement represents:

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** | **2006** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million (unaudited)* |
| *Current tax* | | | | | |
| Provision for Hong Kong profits tax at 17.5% of the estimated assessable profits for the year/period | 1 | 1 | 1 | 1 | 1 |
| *Deferred tax charge/(credit)* | | | | | |
| Origination and reversal of temporary differences | 52 | 68 | 99 | 7 | (21) |
| | 53 | 69 | 100 | 8 | (20) |

The provision for Hong Kong profits tax is all in respect of the estimated assessable profits for the years/periods of the subsidiaries of the Corporation. The Corporation sustained a loss for tax purposes during each year/period and has accumulated tax losses carried forward of approximately $10,800 million, $9,700 million, $7,100 million, $11,700 million and $10,500 million (unaudited) at 31 December 2006, 2005 and 2004 and 30 June 2007 and 2006, respectively, which are available to set off against future assessable profits. The tax losses do not expire under current tax legislation.

(b) Reconciliation between tax expense/(credit) and accounting profit/(loss) at applicable tax rates:

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** | **2006** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million (unaudited)* |
| Profit/(loss) before taxation | 331 | 386 | 613 | 27 | (80) |
| Tax on accounting profit/(loss) before taxation at 17.5% | 58 | 67 | 107 | 5 | (14) |
| Tax effect of non-deductible expenses | 31 | 33 | 30 | 11 | 15 |
| Tax effect of non-taxable revenue | (36) | (31) | (37) | (8) | (21) |
| Actual tax expense/(credit) | 53 | 69 | 100 | 8 | (20) |

(c) Current tax in the consolidated balance sheet represents:

| | As at 31 December | | | As at 30 June |
|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2007 |
| | $million | $million | $million | $million |
| Provision for Hong Kong profits tax for the year/period | 1 | 1 | 1 | 1 |
| Provisional profits tax paid | (1) | (1) | (1) | (1) |
| | — | — | — | — |

(d) Deferred tax assets and liabilities of the KCRC Group and the Corporation recognised:

The components of deferred tax (assets)/liabilities of the KCRC Group and the Corporation recognised in the KCRC Group's and the Corporation's balance sheet and the movements during the years/periods are as follows:

**The KCRC Group**

| | Future benefit of tax losses | Depreciation allowances in excess of the related depreciation | Revaluation of investment properties | Total |
|---|---|---|---|---|
| | $ million | $ million | $ million | $ million |
| At 1 January 2004 | (665) | 3,796 | 21 | 3,152 |
| Charged/(credited) to the income statement | (585) | 658 | 26 | 99 |
| At 31 December 2004 | (1,250) | 4,454 | 47 | 3,251 |
| At 1 January 2005 | | | | |
| — before opening balance adjustments | (1,250) | 4,454 | 47 | 3,251 |
| — opening balance adjustments arising from changes in accounting policies | (121) | — | — | (121) |
| — as restated, after opening balance adjustments | (1,371) | 4,454 | 47 | 3,130 |
| Charged/(credited) to the income statement | (336) | 374 | 30 | 68 |
| At 31 December 2005 | (1,707) | 4,828 | 77 | 3,198 |
| At 1 January 2006 | (1,707) | 4,828 | 77 | 3,198 |
| Charged/(credited) to the income statement | (189) | 224 | 17 | 52 |
| At 31 December 2006 | (1,896) | 5,052 | 94 | 3,250 |
| At 1 January 2007 | (1,896) | 5,052 | 94 | 3,250 |
| Charged/(credited) to the income statement | (152) | 158 | 1 | 7 |
| At 30 June 2007 | (2,048) | 5,210 | 95 | 3,257 |

**The Corporation**

| | Future benefit of tax losses | Depreciation allowances in excess of the related depreciation | Revaluation of investment properties | Total |
|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* |
| At 1 January 2004 | (665) | 3,796 | 21 | 3,152 |
| Charged/(credited) to the income statement | (585) | 658 | 26 | 99 |
| At 31 December 2004 | (1,250) | 4,454 | 47 | 3,251 |
| At 1 January 2005 | | | | |
| — before opening balance adjustments | (1,250) | 4,454 | 47 | 3,251 |
| — opening balance adjustments arising from changes in accounting policies | (121) | — | — | (121) |
| — as restated, after opening balance adjustments | (1,371) | 4,454 | 47 | 3,130 |
| Charged/(credited) to the income statement | (336) | 374 | 30 | 68 |
| At 31 December 2005 | (1,707) | 4,828 | 77 | 3,198 |
| At 1 January 2006 | (1,707) | 4,828 | 77 | 3,198 |
| Charged/(credited) to the income statement | (189) | 225 | 17 | 53 |
| At 31 December 2006 | (1,896) | 5,053 | 94 | 3,251 |
| At 1 January 2007 | (1,896) | 5,053 | 94 | 3,251 |
| Charged/(credited) to the income statement | (150) | 157 | 1 | 8 |
| At 30 June 2007 | (2,046) | 5,210 | 95 | 3,259 |

*The deferred tax assets and liabilities as at 30 June 2007 are expected to be recovered or settled after 12 months.*

### 11 Profit/(loss) for the year/period wholly attributable to the sole shareholder of the Corporation

Of the consolidated profit/loss for the years ended 31 December 2006, 2005 and 2004 and for the six months ended 30 June 2007 and 2006 amounting to profit of $278 million, profit of $317 million, profit of $513 million, profit of $19 million and loss of $60 million, respectively, profit of $252 million, profit of $336 million, profit of $502 million, nil and loss of $73 million have been dealt with in the financial statements of the Corporation, respectively.

**12 Proposed dividend**

(a) Dividend payable to the sole shareholder of the Corporation attributable to the year/period:

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** | **2006** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million (unaudited)* |
| Final dividend proposed after the balance sheet date | 82 | — | 172 | — | — |
| Final dividend per share proposed after the balance sheet date (dollars) | 209.61 | — | 439.67 | — | — |

The final dividend proposed after the balance sheet date has not been recognised as a liability at the balance sheet date.

(b) Dividend payable to the sole shareholder of the Corporation attributable to the previous financial year, approved and paid during the years/periods:

| | Year ended 31 December | | | Six months ended 30 June | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** | **2006** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million (unaudited)* |
| Final dividend in respect of the previous financial year, approved and paid during the year/period | — | 172 | 620 | 82 | — |
| Final dividend per share in respect of the previous financial year, approved and paid during the year/period (dollars) | — | 439.67 | 1,584.87 | 209.61 | — |

**13 Segmental reporting**

Business segment information is chosen as the primary reporting format because this is more relevant to the KCRC Group's internal financial reporting. According to HKAS 14, a business segment is a distinguishable component of an enterprise that is engaged for providing an individual product or service and is subject to risks and returns different from other business segments. In determining the nature of risks and returns, HKAS 14 states that an enterprise's internal organisational and management structure and its system of internal financial reporting form the basis for identifying the predominant source and nature of risks and returns facing the enterprise.

No geographical segment information is shown as virtually all of the turnover and operating profit is derived from activities in Hong Kong.

**2006**

*Operating results*

| | Transport services segment *$ million* | Property segment *$ million* | Consolidated total *$ million* |
|---|---|---|---|
| Revenue | 4,746 | 876 | 5,622 |
| Operating costs before depreciation and amortisation | (2,690) | (137) | (2,827) |
| Inter-segment charges [(1)] | 40 | (40) | — |
| Depreciation and amortisation | (2,233) | (38) | (2,271) |
| Result after depreciation and amortisation | (137) | 661 | 524 |
| Profit from property development | — | 427 | 427 |
| Net valuation gains on investment properties | — | 99 | 99 |
| Result | (137) | 1,187 | 1,050 |
| Unallocated corporate expenses, depreciation and amortisation | | | (232) |
| Interest and finance income | | | 499 |
| Interest and finance expenses | | | (815) |
| Share of profit of associate | | | 27 |
| Losses on changes in fair value of derivative financial instruments and hedged borrowings | | | (198) |
| Income tax | | | (53) |
| Profit after taxation | | | 278 |

(1) Inter-segment charges represent cost recoveries from other segments for services rendered.

*Assets and liabilities*

| | **Transport services segment** *$ million* | **Property segment** *$ million* | **Consolidated total** *$ million* |
|---|---|---|---|
| Assets | 63,786 | 2,049 | 65,835 |
| Properties under development | — | 449 | 449 |
| Interest in associate | — | — | 99 |
| Railways under construction[@] | — | — | 14,722 |
| Unallocated assets[#] | — | — | 6,870 |
| | 63,786 | 2,498 | 87,975 |
| Liabilities | 339 | 714 | 1,053 |
| Deferred income | 325 | 202 | 527 |
| Unallocated liabilities * | — | — | 26,462 |
| | 664 | 916 | 28,042 |

@ Comprising construction and land costs of Lok Ma Chau and Kowloon Southern Link ($13,333 million) and planning and design costs of Shatin to Central Link and Express Rail Link/Northern Link ($1,389 million).

# Comprising corporate assets and construction in progress for corporate office ($317 million), derivative financial assets ($92 million), loan to non-controlled subsidiary ($4,022 million), interest and other receivables ($492 million) and cash and cash equivalents ($1,947 million).

* Comprising interest-bearing borrowings ($19,212 million), accrued charges and provisions for capital projects ($1,983 million), interest and other payables ($1,477 million), deferred tax liabilities ($3,250 million) and derivative financial liabilities ($540 million).

*Other information*

| | **Transport services segment** *$ million* | **Property segment** *$ million* | **Consolidated total** *$ million* |
|---|---|---|---|
| Capital expenditure | | | |
| — Operational railways | 414 | 74 | 488 |
| — Railways under construction | — | — | 2,817 |
| — Unallocated capital expenditure | — | — | 12 |
| | 414 | 74 | 3,317 |

**2005**

*Operating results*

| | Transport services segment | Property segment | Consolidated total |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Revenue | 4,612 | 771 | 5,383 |
| Operating costs before depreciation and amortisation | (2,646) | (153) | (2,799) |
| Inter-segment charges [(1)] | 38 | (38) | — |
| Depreciation and amortisation | (2,208) | (30) | (2,238) |
| Result after depreciation and amortisation | (204) | 550 | 346 |
| Net valuation gains on investment properties | — | 171 | 171 |
| Result | (204) | 721 | 517 |
| Unallocated corporate expenses, depreciation and amortisation | | | (248) |
| Interest and finance income | | | 525 |
| Interest and finance expenses | | | (823) |
| Share of profit of associate | | | 15 |
| Gains on changes in fair value of derivative financial instruments and hedged borrowings | | | 400 |
| Income tax | | | (69) |
| Profit after taxation | | | 317 |

(1) Inter-segment charges represent cost recoveries from other segments for services rendered.

*Assets and liabilities*

| | Transport services segment | Property segment | Consolidated total |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Assets | 65,509 | 1,971 | 67,480 |
| Properties under development | — | 1,537 | 1,537 |
| Interest in associate | — | — | 72 |
| Railways under construction @ | — | — | 11,165 |
| Unallocated assets # | — | — | 9,498 |
| | 65,509 | 3,508 | 89,752 |
| Liabilities | 645 | 671 | 1,316 |
| Deferred income | 350 | 191 | 541 |
| Unallocated liabilities * | — | — | 28,242 |
| | 995 | 862 | 30,099 |

@ Comprising construction and land costs of Lok Ma Chau and Kowloon Southern Link ($9,955 million) and planning and design costs of Shatin to Central Link and Express Rail Link/Northern Link ($1,210 million).

# Comprising corporate assets and construction in progress for corporate office ($341 million), derivative financial assets ($129 million), investments ($449 million), loans to third party ($684 million), loan to non-controlled subsidiary ($3,863 million), interest and other receivables ($638 million) and cash and cash equivalents ($3,394 million).

* Comprising interest-bearing borrowings ($19,474 million), accrued charges and provisions for capital projects ($2,912 million), lease payable ($684 million), interest and other payables ($1,613 million), deferred tax liabilities ($3,198 million) and derivative financial liabilities ($361 million).

*Other information*

| | **Transport services segment** | **Property segment** | **Consolidated total** |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Capital expenditure | | | |
| — Operational railways | 1,165 | 127 | 1,292 |
| — Railways under construction | — | — | 2,535 |
| — Unallocated capital expenditure | — | — | 8 |
| | 1,165 | 127 | 3,835 |

**2004**

*Operating results*

| | **Transport services segment** | **Property segment** | **Consolidated Total** |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Revenue | 4,281 | 695 | 4,976 |
| Operating costs before depreciation and amortisation | (2,447) | (128) | (2,575) |
| Inter-segment charges [(1)] | 35 | (35) | — |
| Depreciation and amortisation | (1,630) | (29) | (1,659) |
| Result after depreciation and amortisation | 239 | 503 | 742 |
| Net valuation gains on investment properties | — | 148 | 148 |
| Result | 239 | 651 | 890 |
| Unallocated corporate expenses, depreciation and amortisation | | | (251) |
| Interest and finance income | | | 444 |
| Interest and finance expenses | | | (485) |
| Share of profit of associate | | | 15 |
| Income tax | | | (100) |
| Profit after taxation | | | 513 |

(1) Inter-segment charges represent cost recoveries from other segments for services rendered.

*Assets and liabilities*

| | Transport services segment | Property segment | Consolidated Total |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Assets | 66,530 | 1,682 | 68,212 |
| Properties under development | — | 1,892 | 1,892 |
| Interest in associate | — | — | 57 |
| Railways under construction [@] | — | — | 7,981 |
| Unallocated assets [#] | — | — | 13,244 |
| | 66,530 | 3,574 | 91,386 |
| Liabilities | 367 | 636 | 1,003 |
| Deferred income | 584 | 124 | 708 |
| Unallocated liabilities * | — | — | 29,613 |
| | 951 | 760 | 31,324 |

[@] Comprising construction and land costs of Lok Ma Chau ($6,519 million) and planning and design costs of Shatin to Central Link, Kowloon Southern Link and Northern Link ($1,462 million).

[#] Comprising corporate assets and construction in progress for corporate office ($409 million), investments ($4,323 million), loans to third party ($733 million), loan to non-controlled subsidiary ($3,576 million), interest and other receivables ($672 million) and cash and cash equivalents ($3,531 million).

* Comprising interest-bearing borrowings ($19,748 million), accrued charges and provisions for capital projects ($3,875 million), lease payable ($717 million), interest and other payables ($2,022 million) and deferred tax liabilities ($3,251 million).

*Other information*

| | Transport services segment | Property segment | Consolidated total |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Capital expenditure | | | |
| — Operational railways | 6,678 | 61 | 6,739 |
| — Railways under construction | — | — | 2,278 |
| — Unallocated capital expenditure | — | — | 8 |
| | 6,678 | 61 | 9,025 |

**Six months ended 30 June 2007**

*Operating results*

| | Transport services segment | Property segment | Consolidated total |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Revenue | 2,367 | 471 | 2,838 |
| Operating costs before depreciation and amortisation | (1,331) | (66) | (1,397) |
| Inter-segment charges[(1)] | 15 | (15) | — |
| Depreciation and amortisation | (1,124) | (21) | (1,145) |
| Result after depreciation and amortisation | (73) | 369 | 296 |
| Net valuation gains on investment properties | — | 6 | 6 |
| Result | (73) | 375 | 302 |
| Unallocated corporate expenses, depreciation and amortisation | | | (142) |
| Interest and finance income | | | 213 |
| Interest and finance expenses | | | (645) |
| Share of profit of associate | | | 16 |
| Gains on changes in fair value of derivative financial instruments and hedged borrowings | | | 283 |
| Income tax | | | (8) |
| Profit after taxation | | | 19 |

(1) Inter-segment charges represent cost recoveries from other segments for services rendered.

**At 30 June 2007**

*Assets and liabilities*

| | Transport services segment | Property segment | Consolidated total |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Assets | 62,947 | 2,043 | 64,990 |
| Properties under development | — | 457 | 457 |
| Interest in associate | — | — | 115 |
| Railways under construction[@] | — | — | 16,325 |
| Unallocated assets[#] | — | — | 5,492 |
| | 62,947 | 2,500 | 87,379 |
| Liabilities | 427 | 725 | 1,152 |
| Deferred income | 313 | 249 | 562 |
| Unallocated liabilities* | — | — | 25,795 |
| | 740 | 974 | 27,509 |

@ Comprising construction and land costs of Lok Ma Chau and Kowloon Southern Link ($14,835 million) and planning and design costs of Shatin to Central Link and Express Rail Link/Northern Link ($1,490 million).

# Comprising corporate assets and construction in progress for corporate office ($306 million), derivative financial assets ($70 million), loan to non-controlled subsidiary ($4,214 million), interest and other receivables ($357 million) and cash and cash equivalents ($545 million).

* Comprising interest-bearing borrowings ($17,839 million), accrued charges and provisions for capital projects ($2,025 million), interest and other payables ($1,368 million), short-term bank loan ($1,013 million), deferred tax liabilities ($3,257 million) and derivative financial liabilities ($293 million).

**Six months ended 30 June 2007**

*Other information*

| | Transport services segment | Property segment | Consolidated total |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Capital expenditure | | | |
| — Operational railways | 297 | 12 | 309 |
| — Railways under construction | — | — | 1,350 |
| — Unallocated capital expenditure | — | — | 9 |
| | 297 | 12 | 1,668 |

**Six months ended 30 June 2006 (unaudited)**

*Operating results*

| | Transport services segment | Property segment | Consolidated total |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Revenue | 2,310 | 426 | 2,736 |
| Operating costs before depreciation and amortisation | (1,319) | (60) | (1,379) |
| Inter-segment charges [(1)] | 20 | (20) | — |
| Depreciation and amortisation | (1,109) | (18) | (1,127) |
| Result after depreciation and amortisation | (98) | 328 | 230 |
| Net valuation gains on investment properties | — | 43 | 43 |
| Result | (98) | 371 | 273 |
| Unallocated corporate expenses, depreciation and amortisation | | | (105) |
| Interest and finance income | | | 257 |
| Interest and finance expenses | | | (404) |
| Share of profit of associate | | | 11 |
| Losses on changes in fair value of derivative financial instruments and hedged borrowings | | | (112) |
| Income tax | | | 20 |
| Loss after taxation | | | (60) |

(1) Inter-segment charges represent cost recoveries from other segments for services rendered.

**14 Fixed assets and interest in leasehold land held for own use under operating leases**

(a) The KCRC Group

| | Investment properties<br>*$ million* | Tunnels, bridges, roads and permanent way<br>*$ million* | Buildings<br>*$ million* | Rolling stock<br>*$ million* | Other equipment<br>*$ million* | Total fixed assets<br>*$ million* | Interest in leasehold land held for own use<br>*$ million* |
|---|---|---|---|---|---|---|---|
| ***Cost or valuation:*** | | | | | | | |
| At 1 January 2004 | 878 | 13,344 | 20,297 | 8,055 | 8,997 | 51,571 | 7,011 |
| Reclassification | — | 2,121 | 233 | — | (28) | 2,326 | (2,326) |
| Transfer from construction in progress | — | 4,118 | 7,172 | 1,219 | 2,123 | 14,632 | 218 |
| Additions | — | 338 | 1,159 | 8 | 87 | 1,592 | 1,010 |
| Disposals | — | (7) | (3) | — | (90) | (100) | — |
| Fair value adjustment | 148 | — | — | — | — | 148 | — |
| At 31 December 2004 | 1,026 | 19,914 | 28,858 | 9,282 | 11,089 | 70,169 | 5,913 |
| At 1 January 2005 | 1,026 | 19,914 | 28,858 | 9,282 | 11,089 | 70,169 | 5,913 |
| Transfer from construction in progress | — | 43 | 282 | (4) | 314 | 635 | — |
| Additions/(reversal of over-accruals) | — | 284 | 313 | (7) | 37 | 627 | 72 |
| Disposals | (26) | (16) | (6) | — | (68) | (116) | — |
| Fair value adjustment | 171 | — | — | — | — | 171 | — |
| At 31 December 2005 | 1,171 | 20,225 | 29,447 | 9,271 | 11,372 | 71,486 | 5,985 |
| At 1 January 2006 | 1,171 | 20,225 | 29,447 | 9,271 | 11,372 | 71,486 | 5,985 |
| Transfer from construction in progress | 112 | 11 | 41 | 4 | 265 | 433 | 7 |
| Additions/(reversal of over-accruals) | — | (6) | 199 | 1 | 54 | 248 | (9) |
| Disposals | (4) | (20) | (1) | (3) | (49) | (77) | — |
| Fair value adjustment | 99 | — | — | — | — | 99 | — |
| At 31 December 2006 | 1,378 | 20,210 | 29,686 | 9,273 | 11,642 | 72,189 | 5,983 |
| At 1 January 2007 | 1,378 | 20,210 | 29,686 | 9,273 | 11,642 | 72,189 | 5,983 |
| Transfer from construction in progress | — | — | 132 | — | 60 | 192 | — |
| Additions | — | 44 | 8 | 5 | 25 | 82 | 7 |
| Disposals | — | (10) | — | (5) | (45) | (60) | — |
| Fair value adjustment | 6 | — | — | — | — | 6 | — |
| At 30 June 2007 | 1,384 | 20,244 | 29,826 | 9,273 | 11,682 | 72,409 | 5,990 |
| ***Accumulated depreciation and amortisation:*** | | | | | | | |
| At 1 January 2004 | — | 183 | 970 | 2,005 | 3,465 | 6,623 | 102 |
| Reclassification | — | (1) | — | — | (7) | (8) | 8 |
| Charge for the year | — | 202 | 448 | 239 | 686 | 1,575 | 112 |
| Written back on disposals | — | — | (1) | — | (75) | (76) | — |
| At 31 December 2004 | — | 384 | 1,417 | 2,244 | 4,069 | 8,114 | 222 |
| At 1 January 2005 | — | 384 | 1,417 | 2,244 | 4,069 | 8,114 | 222 |
| Charge for the year | — | 464 | 600 | 275 | 804 | 2,143 | 118 |
| Written back on disposals | — | (1) | (2) | — | (66) | (69) | — |
| At 31 December 2005 | — | 847 | 2,015 | 2,519 | 4,807 | 10,188 | 340 |
| At 1 January 2006 | — | 847 | 2,015 | 2,519 | 4,807 | 10,188 | 340 |
| Charge for the year | — | 473 | 610 | 274 | 816 | 2,173 | 119 |
| Written back on disposals | — | (2) | — | (3) | (43) | (48) | — |
| At 31 December 2006 | — | 1,318 | 2,625 | 2,790 | 5,580 | 12,313 | 459 |
| At 1 January 2007 | — | 1,318 | 2,625 | 2,790 | 5,580 | 12,313 | 459 |
| Charge for the period | — | 237 | 305 | 137 | 416 | 1,095 | 60 |
| Written back on disposals | — | (2) | — | (4) | (35) | (41) | — |
| At 30 June 2007 | — | 1,553 | 2,930 | 2,923 | 5,961 | 13,367 | 519 |
| ***Carrying amounts:*** | | | | | | | |
| At 30 June 2007 | 1,384 | 18,691 | 26,896 | 6,350 | 5,721 | 59,042 | 5,471 |
| At 31 December 2006 | 1,378 | 18,892 | 27,061 | 6,483 | 6,062 | 59,876 | 5,524 |
| At 31 December 2005 | 1,171 | 19,378 | 27,432 | 6,752 | 6,565 | 61,298 | 5,645 |
| At 31 December 2004 | 1,026 | 19,530 | 27,441 | 7,038 | 7,020 | 62,055 | 5,691 |

(b) The Corporation

| | Investment properties<br>$ million | Tunnels, bridges, roads, and permanent way<br>$ million | Buildings<br>$ million | Rolling stock<br>$ million | Other equipment<br>$ million | Total fixed assets<br>$ million | Interest in leasehold land held for own use<br>$ million |
|---|---|---|---|---|---|---|---|
| ***Cost or valuation:*** | | | | | | | |
| At 1 January 2004 | 878 | 13,344 | 20,297 | 8,055 | 8,960 | 51,534 | 7,011 |
| Reclassification | — | 2,121 | 233 | — | (28) | 2,326 | (2,326) |
| Transfer from construction in progress | — | 4,118 | 7,172 | 1,219 | 2,106 | 14,615 | 218 |
| Additions/(reversal of over-accruals) | — | 338 | 1,159 | 8 | 87 | 1,592 | 1,010 |
| Disposals | — | (7) | (3) | — | (90) | (100) | — |
| Fair value adjustment | 148 | — | — | — | — | 148 | — |
| At 31 December 2004 | 1,026 | 19,914 | 28,858 | 9,282 | 11,035 | 70,115 | 5,913 |
| At 1 January 2005 | 1,026 | 19,914 | 28,858 | 9,282 | 11,035 | 70,115 | 5,913 |
| Transfer from construction in progress | — | 43 | 282 | (4) | 317 | 638 | — |
| Additions/(reversal of over-accruals) | — | 284 | 313 | (7) | 37 | 627 | 72 |
| Disposals | (26) | (16) | (6) | — | (68) | (116) | — |
| Fair value adjustment | 171 | — | — | — | — | 171 | — |
| At 31 December 2005 | 1,171 | 20,225 | 29,447 | 9,271 | 11,321 | 71,435 | 5,985 |
| At 1 January 2006 | 1,171 | 20,225 | 29,447 | 9,271 | 11,321 | 71,435 | 5,985 |
| Transfer from construction in progress | 112 | 11 | 41 | 4 | 265 | 433 | 7 |
| Additions/(reversal of over-accruals) | — | (6) | 199 | 1 | 54 | 248 | (9) |
| Disposals | (4) | (20) | (1) | (3) | (49) | (77) | — |
| Fair value adjustment | 99 | — | — | — | — | 99 | — |
| At 31 December 2006 | 1,378 | 20,210 | 29,686 | 9,273 | 11,591 | 72,138 | 5,983 |
| At 1 January 2007 | 1,378 | 20,210 | 29,686 | 9,273 | 11,591 | 72,138 | 5,983 |
| Transfer from construction in progress | — | — | 132 | — | 60 | 192 | — |
| Additions | — | 44 | 8 | 5 | 25 | 82 | 7 |
| Disposals | — | (10) | — | (5) | (45) | (60) | — |
| Fair value adjustment | 6 | — | — | — | — | 6 | — |
| At 30 June 2007 | 1,384 | 20,244 | 29,826 | 9,273 | 11,631 | 72,358 | 5,990 |
| ***Accumulated depreciation and amortisation:*** | | | | | | | |
| At 1 January 2004 | — | 183 | 970 | 2,005 | 3,465 | 6,623 | 102 |
| Reclassification | — | (1) | — | — | (7) | (8) | 8 |
| Charge for the year | — | 202 | 448 | 239 | 682 | 1,571 | 112 |
| Written back on disposals | — | — | (1) | — | (75) | (76) | — |
| At 31 December 2004 | — | 384 | 1,417 | 2,244 | 4,065 | 8,110 | 222 |
| At 1 January 2005 | — | 384 | 1,417 | 2,244 | 4,065 | 8,110 | 222 |
| Charge for the year | — | 464 | 600 | 275 | 798 | 2,137 | 118 |
| Written back on disposals | — | (1) | (2) | — | (66) | (69) | — |
| At 31 December 2005 | — | 847 | 2,015 | 2,519 | 4,797 | 10,178 | 340 |
| At 1 January 2006 | — | 847 | 2,015 | 2,519 | 4,797 | 10,178 | 340 |
| Charge for the year | — | 473 | 610 | 274 | 811 | 2,168 | 119 |
| Written back on disposals | — | (2) | — | (3) | (43) | (48) | — |
| At 31 December 2006 | — | 1,318 | 2,625 | 2,790 | 5,565 | 12,298 | 459 |
| At 1 January 2007 | — | 1,318 | 2,625 | 2,790 | 5,565 | 12,298 | 459 |
| Charge for the period | — | 237 | 305 | 137 | 414 | 1,093 | 60 |
| Written back on disposals | — | (2) | — | (4) | (35) | (41) | — |
| At 30 June 2007 | — | 1,553 | 2,930 | 2,923 | 5,944 | 13,350 | 519 |
| ***Carrying amounts:*** | | | | | | | |
| At 30 June 2007 | 1,384 | 18,691 | 26,896 | 6,350 | 5,687 | 59,008 | 5,471 |
| At 31 December 2006 | 1,378 | 18,892 | 27,061 | 6,483 | 6,026 | 59,840 | 5,524 |
| At 31 December 2005 | 1,171 | 19,378 | 27,432 | 6,752 | 6,524 | 61,257 | 5,645 |
| At 31 December 2004 | 1,026 | 19,530 | 27,441 | 7,038 | 6,970 | 62,005 | 5,691 |

(c) Permanent way principally comprises the cost of rail tracks, sleepers, track base and ballast.

(d) Other equipment comprises lifts and escalators, telecommunication and signalling systems, machinery, furniture and fixtures, motor vehicles and computer and office equipment.

(e) The KCRC Group and the Corporation lease out investment properties and certain properties which are either used in or ancillary to the KCRC Group's and Corporation's rail business, under operating leases. The leases typically run for an initial period of two to five years, with an option to renew the lease after that date at which time all terms are re-negotiated. The leases may include additional rentals based on sales revenue of the tenants in excess of the basic rentals.

(f) The fair values of the Group's and Corporation's investment properties, held in Hong Kong under long-term leases, at each balance sheet date were remeasured on an open market basis, by either making reference to comparable sales in the relevant locality, or otherwise, by capitalising the net income with due allowance for reversionary income potential. For the years ended 31 December 2006, 2005 and 2004, the valuations were carried out by an independent firm of surveyors which has among its staff Fellow and Associate members of the Hong Kong Institute of Surveyors and The Royal Institution of Chartered Surveyors with good valuation experience in Hong Kong. For the periods ended 30 June 2007 and 2006, the valuations were carried out by management of the Corporation. The net fair value gain of $99 million, $171 million, $148 million and $6 million has been transferred to the income statement for the years ended 31 December 2006, 2005 and 2004 and for the six months ended 30 June 2007, respectively.

(g) Other than investment properties, included in fixed assets are assets leased out under operating leases with gross carrying amounts and related accumulated depreciation charges as follows:

| | **As at 31 December** | | | | | | **As at 30 June** | |
|---|---|---|---|---|---|---|---|---|
| | **2006** | | **2005** | | **2004** | | **2007** | |
| | **Gross carrying amount** | **Related accumulated depreciation** | **Gross carrying amount** | **Related accumulated depreciation** | **Gross carrying amount** | **Related accumulated depreciation** | **Gross carrying amount** | **Related accumulated depreciation** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Goods yard at Hung Hom Bay | 84 | 13 | 85 | 11 | 85 | 9 | 68 | 11 |
| Hung Hom Station Car Park | 55 | 25 | 56 | 24 | 55 | 22 | 55 | 25 |
| Offices at Hung Hom Station | 23 | 7 | 23 | 6 | 21 | 6 | 23 | 7 |
| Offices at Hung Hom freight building | 6 | 1 | 6 | 1 | 6 | 1 | 6 | 1 |
| Citylink Plaza at Sha Tin Station | 144 | 68 | 144 | 63 | 104 | 60 | 164 | 80 |
| Goods yard at Mongkok Station | 45 | 8 | 45 | 7 | 45 | 6 | 45 | 9 |
| Shops at stations | 802 | 93 | 764 | 81 | 672 | 59 | 775 | 101 |
| Mobile phone coverage system | 84 | 48 | 84 | 43 | 87 | 37 | 84 | 51 |
| Trackside Villas | 36 | 9 | 30 | 7 | 19 | 4 | 38 | 10 |
| | 1,279 | 272 | 1,237 | 243 | 1,094 | 204 | 1,258 | 295 |

Although these properties are leased to tenants, they are not held for their investment potential. These assets are situated on railway land vested in the Corporation by the Government for railway purposes and are either used in or are ancillary to the KCRC Group's railway business. They are an integral part of the railway network and cannot be sold separately without the agreement of the Government. Accordingly, these assets are not classified as investment properties.

(h) The minimum total future amounts received by the KCRC Group and Corporation under non-cancellable operating leases are expected to be received as follows:

| | As at 31 December | | | As at 30 June |
|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Within one year | 896 | 663 | 659 | 967 |
| After one year but within five years | 1,739 | 704 | 914 | 1,570 |
| After five years | 155 | 15 | 41 | 26 |
| | 2,790 | 1,382 | 1,614 | 2,563 |

(i) The KCRC Group and Corporation have entered into a number of individually structured transactions or arrangements with unrelated parties to lease out and lease back assets which include rolling stock, signalling equipment, revenue collection equipment and railway infrastructure. Under each arrangement, the KCRC Group and Corporation have leased the assets to an overseas investor, who has prepaid all the rentals in relation to a lease agreement. Simultaneously, the KCRC Group and Corporation have leased the assets back from the overseas investor and will pay the rentals on a semi-annual or annual basis in accordance with a pre-determined payment schedule. The KCRC Group and Corporation have an option to purchase the overseas investor's leasehold interest in the assets at a pre-determined date for a fixed or agreed amount and it is the intention of the KCRC Group and Corporation to exercise such purchase options. The rental prepayments received from the overseas investor have been placed in deposits or invested in debt securities, or loaned to an unrelated party, the repayments of which are expected to be sufficient to meet the KCRC Group's and Corporation's rental obligations and the amounts payable for exercising the purchase options under the lease agreements. As long as the KCRC Group and Corporation comply with the requirements of the lease agreements, the KCRC Group and Corporation will continue to be entitled to quiet enjoyment of and continued possession, use or operation of the assets subject to these arrangements. The arrangements have been entered into with investors in the United States.

As at 31 December 2006, 2005 and 2004 and 30 June 2007, a portion of the Group's and Corporation's assets (including assets replaced during the lease periods) with a total cost of $10,163 million, $11,919 million, $11,819 million and $10,171 million, respectively, and net book value of $5,572 million, $7,579 million, $7,913 million and $5,394 million, respectively, is covered by eight, nine, nine and eight arrangements, respectively. As at 31 December 2006, 2005, 2004 and 30 June 2007, five, six, six and five arrangements respectively involve rolling stock, with basic lease terms of 15 to 28 years, respectively. Two arrangements, one involving signalling equipment and the other involving the revenue collection system, have a basic lease term of 15 years. The remaining arrangement involving railway infrastructure has basic lease terms of between 24 years and 27 years. Since the Group and Corporation retain risks and rewards incidental to ownership of the underlying assets in respect of each arrangement and enjoy substantially the same rights to their use as before the arrangements were entered into, no adjustment has been made to fixed assets. As a result of the eight, nine, nine and eight arrangements in the years ended 31 December 2006, 2005 and 2004 and the six months ended 30 June 2007, respectively, the Group and Corporation have received cash of $10,805 million, $13,480 million, $13,480 million and $10,805 million, respectively, and, assuming exercise of the purchase option in each arrangement, will be obligated to make long-term lease payments over the duration of the relevant leases with a total estimated net present value at the inception of the arrangements of $10,292 million, $12,681 million, $12,681 million and $10,292 million, respectively, the obligations of which are expected to be funded by the proceeds to be generated from existing deposits and investments and the loan repayments from a third party over the relevant lease periods.

The total net amounts of cash received by the Group and Corporation from the arrangements have been recorded as deferred income and are being amortised to the income statement over the applicable lease terms of the arrangements. The total amount of $24 million, $39 million, $39 million and $12 million, respectively, recognised for the years ended 31 December 2006, 2005 and 2004 and for the six months ended 30 June 2007, has been included in the transport services segment in the income statement.

(j) Included in additions are amounts paid and payable or received and receivable to the Government by the Corporation in respect of the following:

— $21 million, $18 million, $143 million and $7 million for land resumption work on the West Rail, Ma On Shan Rail and Tsim Sha Tsui Extension projects undertaken by the Government on behalf of the Corporation and for lease of land required for construction sites for the years ended 31 December 2006, 2005 and 2004 and for the six months ended 30 June 2007, respectively.

— $958 million for compensation in respect of resumed land in relation to the West Rail project paid and payable by the Government on behalf of the Corporation for the year ended 31 December 2004. The Corporation is obligated to reimburse such sums to the Government.

— Refund of $25 million, accrual of $50 million, refund of $150 million and nil for land premiums payable by the Corporation in respect of the East Rail Extensions project for the years ended 31 December 2006, 2005 and 2004 and for the six months ended 30 June 2007, respectively.

(k) The carrying value of the KCRC Group's and Corporation's interest in leasehold land held in Hong Kong as at 31 December 2006, 2005, 2004 and 30 June 2007 is $5,497 million, $5,617 million, $5,663 million and $5,444 million under medium-term leases (10 to 50 years) and $27 million, $28 million, $28 million and $27 million under long-term leases (50 years or above), respectively.

## 15 Construction in progress

Construction in progress comprises:

(a) The KCRC Group

**2006**

| | **Kowloon Southern Link** | **East Rail Extensions** | **Other assets** | **Total construction in progress** |
|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January 2006 | 1,307 | 8,648 | 456 | 10,411 |
| Costs incurred during the year | 1,533 | 1,845 | 295 | 3,673 |
| Transfer to fixed assets or leasehold land | — | — | (440) | (440) |
| Balance as at 31 December 2006 | 2,840 | 10,493 | 311 | 13,644 |

**2005**

| | **Kowloon Southern Link** | **East Rail Extensions** | **Other assets** | **Total construction in progress** |
|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January 2005 | — | 6,514# | 472 | 6,986 |
| Transfer from deferred expenditure | 875 | — | — | 875 |
| Costs incurred during the year | 432 | 2,304 | 449 | 3,185 |
| Transfer to fixed assets or leasehold land | — | (170) | (465) | (635) |
| Balance as at 31 December 2005 | 1,307 | 8,648 | 456 | 10,411 |

# After deduction of an opening balance adjustment of $5 million upon adoption of HKAS 32 and HKAS 39.

**2004**

| | East Rail Extensions | Other assets | Total construction in progress |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January 2004 | 14,091 | 1,010 | 15,101 |
| Costs incurred during the year | 6,158 | 582 | 6,740 |
| Transfer to fixed assets or leasehold land | (13,730) | (1,120) | (14,850) |
| Balance as at 31 December 2004 | 6,519 | 472 | 6,991 |

**30 June 2007**

| | Kowloon Southern Link | East Rail Extensions | Other assets | Total construction in progress |
|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January 2007 | 2,840 | 10,493 | 311 | 13,644 |
| Costs incurred during the period | 973 | 529 | 191 | 1,693 |
| Transfer to fixed assets | — | — | (192) | (192) |
| Balance as at 30 June 2007 | 3,813 | 11,022 | 310 | 15,145 |

(b) The Corporation

**2006**

| | Kowloon Southern Link | East Rail Extensions | Other assets | Total construction in progress |
|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January 2006 | 1,307 | 8,648 | 456 | 10,411 |
| Costs incurred during the year | 1,533 | 1,845 | 295 | 3,673 |
| Transfer to fixed assets or leasehold land | — | — | (440) | (440) |
| Balance as at 31 December 2006 | 2,840 | 10,493 | 311 | 13,644 |

**2005**

| | Kowloon Southern Link | East Rail Extensions | Other assets | Total construction in progress |
|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January 2005 | — | 6,514[#] | 472 | 6,986 |
| Transfer from deferred expenditure | 875 | — | — | 875 |
| Costs incurred during the year | 432 | 2,304 | 449 | 3,185 |
| Transfer from a subsidiary | — | — | 3 | 3 |
| Transfer to fixed assets or leasehold land | — | (170) | (468) | (638) |
| Balance as at 31 December 2005 | 1,307 | 8,648 | 456 | 10,411 |

[#] After deduction of an opening balance adjustment of $5 million upon adoption of HKAS 32 and HKAS 39.

**2004**

| | East Rail Extensions | Other assets | Total construction in progress |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January 2004 | 14,091 | 1,010 | 15,101 |
| Costs incurred during the year | 6,158 | 582 | 6,740 |
| Transfer to a subsidiary | — | (17) | (17) |
| Transfer to fixed assets or leasehold land | (13,730) | (1,103) | (14,833) |
| Balance as at 31 December 2004 | 6,519 | 472 | 6,991 |

**30 June 2007**

| | Kowloon Southern Link | East Rail Extensions | Other assets | Total construction in progress |
|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January 2007 | 2,840 | 10,493 | 311 | 13,644 |
| Costs incurred during the period | 973 | 529 | 191 | 1,693 |
| Transfer to fixed assets | — | — | (192) | (192) |
| Balance as at 30 June 2007 | 3,813 | 11,022 | 310 | 15,145 |

(c) Included in the balances are amounts paid and payable to the Government by the Corporation in respect of the following:

— $632 million, $612 million, $602 million and $639 million as at 31 December 2006, 2005 and 2004 and 30 June 2007, respectively, for the land resumption costs and other costs directly associated with the acquisition of leasehold land held for own use for the construction of the East Rail Extensions.

— $51 million, $24 million, $7 million and $65 million as at 31 December 2006, 2005 and 2004 and 30 June 2007, respectively, for the land resumption costs and other costs directly associated with the acquisition of leasehold land held for own use for the construction of the Kowloon Southern Link.

These costs will be transferred to interest in leasehold land when the land is vested in the Corporation by the Government, at which time the costs will begin to be amortised in accordance with the relevant policies.

(d) Included in costs incurred during the years/periods are amounts paid and payable to the Government by the Corporation in respect of the following:

— $46 million, $13 million and $42 million for the years ended 31 December 2006, 2005 and 2004, respectively, and $19 million for the six months ended 30 June 2007 for the lease of land required for construction sites for the East Rail Extensions and Kowloon Southern Link projects. The land does not have a measurable value as it cannot be assigned and can only be used by the Corporation and/or its contractors.

— $19 million, $9 million and $195 million for the years ended 31 December 2006, 2005 and 2004, respectively, and $10 million for the six months ended 30 June 2007 for land resumption work undertaken by the Government and compensation in respect of resumed land paid and payable by the Government on behalf of the Corporation in respect of the East Rail Extensions and Kowloon Southern Link projects. The Corporation is obligated to reimburse such sums to the Government.

(e) The costs incurred during the years/periods are arrived at after crediting $55 million, $23 million and $75 million for the years ended 31 December 2006, 2005 and 2004, respectively, and $16 million for the six months ended 30 June 2007 on-cost recoveries from the Government for certain essential public infrastructure works and other works along the railways undertaken by the Corporation on its behalf pursuant to the entrustment agreements in respect of such entrustment works and from the subsidiary, West Rail Property Development Limited, for property development along the West Rail, Phase I route as governed by the Shareholding Agreement between the Corporation and the Government (see note 21).

## 16 Deferred expenditure

The KCRC Group and the Corporation

Deferred expenditure comprises:

**2006**

| | **Shatin to Central Link** *$ million* | **Express Rail Link/ Northern Link** *$ million* | **Total deferred expenditure** *$ million* |
|---|---|---|---|
| Balance as at 1 January 2006 | 1,188 | 22 | 1,210 |
| Expenditure during the year | — | 179 | 179 |
| Balance as at 31 December 2006 | 1,188 | 201 | 1,389 |

**2005**

| | Kowloon Southern Link | Shatin to Central Link | Express Rail Link/ Northern Link | Total deferred expenditure |
|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January 2005 | 279 | 1,178# | 4 | 1,461 |
| Expenditure during the year | 569 | 10 | 18 | 597 |
| Interest and finance income/expenses | 27 | — | — | 27 |
| Transfer to construction in progress | (875) | — | — | (875) |
| Balance as at 31 December 2005 | — | 1,188 | 22 | 1,210 |

# After deduction of an opening balance adjustment of $1 million upon adoption of HKAS 32 and HKAS 39.

**2004**

| | Kowloon Southern Link | Shatin to Central Link | Northern Link | Total deferred expenditure |
|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January 2004 | 169 | 731 | — | 900 |
| Expenditure during the year | 107 | 437 | 4 | 548 |
| Interest and finance income/expenses | 3 | 11 | — | 14 |
| Balance as at 31 December 2004 | 279 | 1,179 | 4 | 1,462 |

**30 June 2007**

| | Shatin to Central Link | Express Rail Link/ Northern Link | Total deferred expenditure |
|---|---|---|---|
| | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January 2007 | 1,188 | 201 | 1,389 |
| Expenditure during the period | — | 101 | 101 |
| Balance as at 30 June 2007 | 1,188 | 302 | 1,490 |

(a) The planning, design and construction of the Shatin to Central Link was suspended in 2005 pending the announcement by the Government of its decision on how and by whom the Shatin to Central Link, to which the Government remains committed in principle, would in fact be constructed. The Corporation's expenditure on the Shatin to Central Link is carried in the balance sheet at cost and if the Corporation in due course constructs the Shatin to Central Link, this amount will form part of the final cost of the completed project. If, however, another party were to construct the Shatin to Central Link, it is uncertain whether the Corporation would be able to recover any or all of the expenditure it has incurred on the project, and any shortfall in recovery would be written off to the Corporation's income statement in the appropriate future accounting period.

(b) As at 31 December 2006, 2005 and 2004 and 30 June 2007, land related costs totalling approximately $6 million, $6 million, $8 million and $6 million, respectively, directly associated with the acquisition of leasehold land for the purpose of the Shatin to Central Link are included in the balance of deferred expenditure. These costs will be transferred to interest in leasehold land when the land is vested in the Corporation by the Government, at which time the costs begin to be amortised in accordance with the relevant policies.

**17 Properties under development**

The KCRC Group and the Corporation

| | Year ended 31 December | | | Six months ended 30 June |
|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance as at 1 January | 1,537 | 1,892 | 1,448 | 449 |
| Expenditure incurred during the year/period | 6 | 35 | 444 | 8 |
| Amounts recovered during the year/period | (1,094) | (390) | — | — |
| Balance as at 31 December/30 June | 449 | 1,537 | 1,892 | 457 |

The balance of expenditure on properties under development relates mainly to the property enabling works for development sites at Tai Wai Station and Che Kung Temple Station. Other development projects will be put out to tender from later part of 2007 onwards in accordance with the master programme coordinated with the Government.

Included in the amounts recovered during the year ended 31 December 2005 is a cost recovery of $88 million from the Government in respect of public transport interchange and property development enabling works.

**18 Investments in subsidiaries**

| | Corporation | | | |
|---|---|---|---|---|
| | As at 31 December | | | As at 30 June |
| | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Unlisted shares, at cost | — | — | — | — |

Details of the subsidiaries listed by principal activities are as follows:

| **Name of company** | **Place of incorporation and operation** | **Number of issued and fully paid ordinary shares** | **Par value of shares** | **Percentage of shares held by the Corporation** |
|---|---|---|---|---|
| *Property Management* | | | | |
| Manlai Court Property Management Company Limited # | Hong Kong | 25,500 'A' | $1 | 100% |
| | | 24,500 'B' | $1 | Nil |
| Sun Tuen Mun Centre Management Company Limited | Hong Kong | 25,000 'A' | $1 | 100% |
| | | 25,000 'B' | $1 | 100% |
| Royal Ascot Management Company Limited | Hong Kong | 25,000 'A' | $1 | 100% |
| | | 25,000 'B' | $1 | 100% |
| Hanford Garden Property Management Company Limited | Hong Kong | 10,000 | $1 | 100% |
| Pierhead Garden Management Company Limited | Hong Kong | 25,000 'A' | $1 | 100% |
| | | 25,000 'B' | $1 | 100% |
| The Metropolis Management Company Limited | Hong Kong | 25,500 'A' | $1 | 100% |
| | | 24,500 'B' | $1 | Nil |
| Capital System Limited ## | Hong Kong | 5,000 | $1 | 100% |
| *Asset Leasing* | | | | |
| Buoyant Asset Limited | Hong Kong | 100 | $10 | 100% |
| Advanced Asset Limited | Hong Kong | 100 | $10 | 100% |
| Quality Asset Limited | Hong Kong | 100 | $10 | 100% |
| Kasey Asset Limited | Hong Kong | 100 | $10 | 100% |
| Circuit Asset Limited | Hong Kong | 100 | $10 | 100% |
| Shining Asset Limited | Hong Kong | 100 | $10 | 100% |
| Fluent Asset Limited | Hong Kong | 100 | $10 | 100% |
| Kudos Asset Limited & | Hong Kong | 100 | $10 | 100% |
| Unique Asset Limited & | Hong Kong | 100 | $10 | 100% |
| Bowman Asset Limited | Cayman Islands | 1,000 | US$1 | 100% |
| Statesman Asset Limited | Cayman Islands | 1,000 | US$1 | 100% |
| Interwind Asset Limited @ | Hong Kong | 100 | $10 | 100% |
| Hardy Asset Limited @ | Hong Kong | 100 | $10 | 100% |
| Roving Asset Limited @ | Hong Kong | 100 | $10 | 100% |
| Swanky Asset Limited @ | Hong Kong | 100 | $10 | 100% |
| *Telecommunication* | | | | |
| V-Connect Limited | Hong Kong | 100 | $10 | 100% |
| *Property Development (non-controlled subsidiaries)* | | | | |
| West Rail Property Development Limited, and its 13 wholly owned subsidiaries * | Hong Kong | 51 'A' | $10 | 100% |
| | | 49 'B' | $10 | Nil |

# At 30 June 2007, the subsidiary is in the process of winding up as a result of the termination of the business of property management in Manlai Court.

## At 30 June 2007, the subsidiary is in the process of winding up as it is no longer serving any commercial function.

& At 30 June 2007, the subsidiaries are in the process of winding up as the concerned leasing transaction was terminated in 2006.

@ At 30 June 2007, the subsidiaries are in the process of de-registration as the proposed leasing transactions have not materialised.

* These subsidiaries are held by the Corporation for the sole purpose of developing commercial or residential property along the West Rail, Phase I route on behalf of the Government. Their financial statements are excluded from consolidation as the Corporation has no effective control over nor beneficial interests in the net assets of these subsidiaries, other than the amount of capital provided.

A summary of consolidated financial information of WRPDL and its subsidiaries based on the management accounts of these companies is as follows:

| | As at 31 December | | | As at 30 June |
|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2007 |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Assets | 4,046 | 3,861 | 3,574 | 4,236 |
| Liabilities | 4,048 | 3,863 | 3,576 | 4,238 |
| Equity | (2) | (2) | (2) | (2) |
| Turnover | — | — | — | — |
| Profit/(loss) after taxation for the year/period | — | — | — | (1) |

## 19 Interest in associate

The interest in associate is as follows:

| | KCRC Group | | | | Corporation | | | |
|---|---|---|---|---|---|---|---|---|
| | As at 31 December | | | As at 30 June | As at 31 December | | | As at 30 June |
| | 2006 | 2005 | 2004 | 2007 | 2006 | 2005 | 2004 | 2007 |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Unlisted shares, at cost | — | — | — | — | 9 | 9 | 9 | 9 |
| Share of net assets | 66 | 39 | 57 | 82 | — | — | — | — |
| Loan to associate | 33 | 33 | — | 33 | 33 | 33 | — | 33 |
| | 99 | 72 | 57 | 115 | 42 | 42 | 9 | 42 |

Details of the associate, which is incorporated and operates in Hong Kong, are as follows:

| **Name of company** | **Number of issued and fully paid ordinary shares** | **Par value of shares** | **Percentage of shares held** |
|---|---|---|---|
| Octopus Holdings Limited | 42,000,000 | $1 | 22.1% |

The Corporation and four other local transport companies (including MTRCL) entered into an agreement in 1994 to develop and operate the Octopus cards system through a central body called Octopus Cards Limited.

On 21 October 2005, the Corporation and the other shareholders of Octopus Cards Limited divested themselves of all their shares in Octopus Cards Limited to a new holding company, Octopus Holdings Limited, in consideration for the issue to them of new shares in Octopus Holdings Limited.

Immediately after completion of the sale and purchase of shares in Octopus Cards Limited, the shareholders of Octopus Holdings Limited made a loan in aggregate amounting to $150 million to Octopus Holdings Limited, pursuant to a Subordinated Loan Agreement, with each shareholder lending an amount in proportion to its shareholding in Octopus Holdings Limited. The loan to associate from the Corporation bears interest at 5.5% per annum. It is unsecured and repayable in whole or in part at any time before 20 October 2010. During the year ended 31 December 2006 and the six months ended 30 June 2007, the Group received interest payments from Octopus Holdings Limited, amounting to $2 million and $1 million, respectively.

During the years ended 31 December 2006, 2005 and 2004 and the six months ended 30 June 2007, the Group made payments to Octopus Cards Limited, amounting to $38 million, $36 million, $33 million and $19 million, respectively, in respect of fees for the use of the Octopus cards system. These payments were based on the fare revenue generated from Octopus cards. No other charges were made or incurred by the Group in respect of the administration of the Octopus cards system. The Group received $7 million, $7 million, $8 million and $4 million for the years ended 31 December 2006, 2005 and 2004 and for the six months ended 30 June 2007, respectively, from Octopus Cards Limited in respect of ticket loading agent fees for providing add-value amounts on Octopus cards and handling fees for issuing new cards and handling refunds for returned cards.

A summary of financial information of the associate based on the consolidated management accounts of Octopus Holdings Limited is as follows:

| | **As at 31 December** | | | | | | **As at 30 June** | |
|---|---|---|---|---|---|---|---|---|
| | **2006** | **2006** | **2005** | **2005** | **2004** | **2004** | **2007** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| | | *KCRC Group's effective interest* | | *KCRC Group's effective interest* | | *KCRC Group's effective interest* | | *KCRC Group's effective interest* |
| | *100%* | *(22.1%)* | *100%* | *(22.1%)* | *100%* | *(22.1%)* | *100%* | *(22.1%)* |
| Assets | 2,180 | 482 | 1,833 | 405 | 1,554 | 343 | 2,291 | 506 |
| Liabilities | 1,882 | 416 | 1,653 | 366 | 1,443 | 319 | 1,919 | 424 |
| Equity | 298 | 66 | 180 | 39 | 111 | 24 | 372 | 82 |
| Turnover | 405 | 90 | 354 | 78 | 317 | 70 | 201 | 44 |
| Profit after tax for the year | 118 | 27 | 69 | 15 | 69 | 15 | 74 | 16 |

## 20 Loans to third party

The loans in 2004 and 2005 related to one of the lease arrangements entered into by the KCRC Group and the Corporation. Under such lease arrangement, the future lease payments were to be funded by the interest earned on certain loans to third party and the repayment of those loans. In 2006, the lease arrangement was terminated and those loans to third party were offset against the termination amount payable by the KCRC Group and the Corporation under the agreements for terminating the lease.

## 21 Loan to non-controlled subsidiary

On 24 February 2000, the Corporation and the Government entered into a shareholding agreement (the "Shareholding Agreement") for the formation of a sub-group of the Corporation under an intermediate holding company, West Rail Property Development Limited ("WRPDL"), to undertake all property developments along the West Rail, Phase I route. The issued share capital of WRPDL comprises 51 ordinary "A" shares and 49 ordinary "B" shares, which are held by the Corporation and the Government respectively. The holders of ordinary "A" shares are not entitled to any distribution by WRPDL other than a return of capital, and the holders of ordinary "B" shares are entitled to all dividends declared by WRPDL and a return of capital. In other words, the Corporation is not entitled to any earnings distribution, nor is it required to ultimately fund any losses which may be sustained by WRPDL and its subsidiaries.

All costs incurred or to be incurred in relation to the West Rail property developments are to be funded by loans from the Corporation to WRPDL bearing interest at an annual rate of 1% over the Corporation's average cost of funds in the preceding year. To the extent that WRPDL may be unable to repay the loan, the Government shall seek the necessary authority to reimburse costs incurred by the Corporation. The Government has also undertaken to indemnify the Corporation against all liabilities properly incurred by the Corporation in relation to such property developments.

Subsidiaries of WRPDL have been formed to handle the property developments along the West Rail, Phase I route. The Government will receive the profits less losses from the developments whereby the Corporation will recover the on-costs for the handling of the property developments along the route.

The loan to non-controlled subsidiary is expected to be recovered as follows:

The KCRC Group and the Corporation

| | **As at 31 December** | | | **As at 30 June** |
|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Within one year | 153 | 1,202 | — | 162 |
| After one year | 3,869 | 2,661 | 3,576 | 4,052 |
| | 4,022 | 3,863 | 3,576 | 4,214 |

## 22 Investments

The KCRC Group and the Corporation

Investments comprise:

| | As at 31 December | | | As at 30 June |
|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Available-for-sale debt securities | | | | |
| — Listed outside Hong Kong | — | 31 | 578 | — |
| — Unlisted | — | 369 | 1,645 | — |
| Interest-bearing deposits temporarily placed with the custodian bank | — | 49 | 2,100 | — |
| Total fair value of investments | — | 449 | 4,323 | — |
| Total market value of listed investments | — | 31 | 578 | — |

## 23 Stores and spares

The KCRC Group and the Corporation

Stores and spares are expected to be consumed as follows:

| | As at 31 December | | | As at 30 June |
|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Within one year | 133 | 159 | 164 | 138 |
| After one year | 229 | 184 | 155 | 229 |
| | 362 | 343 | 319 | 367 |

**24 Interest and other receivables**

(a) Interest and other receivables comprise:

| | KCRC Group | | | | Corporation | | | |
|---|---|---|---|---|---|---|---|---|
| | As at 31 December | | | As at 30 June | As at 31 December | | | As at 30 June |
| | **2006** | **2005** | **2004** | **2007** | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Interest receivable | 8 | 42 | 49 | 1 | 8 | 26 | 32 | 1 |
| Amounts due from subsidiaries | — | — | — | — | 12 | 10 | 23 | 12 |
| Amount due from the Government | 312 | 432 | 510 | 320 | 312 | 432 | 510 | 320 |
| Debtors, deposits, prepayments and revenue in arrears | 251 | 243 | 197 | 142 | 246 | 239 | 186 | 139 |
| | 571 | 717 | 756 | 463 | 578 | 707 | 751 | 472 |

The amount due from the Government represents amounts receivable for certain essential public infrastructure works and other works along the railways undertaken on behalf of the Government pursuant to the respective entrustment agreements and project agreements with the Government.

(b) Interest and other receivables are expected to be recovered as follows:

| | KCRC Group | | | | Corporation | | | |
|---|---|---|---|---|---|---|---|---|
| | As at 31 December | | | As at 30 June | As at 31 December | | | As at 30 June |
| | **2006** | **2005** | **2004** | **2007** | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Within one year | 531 | 651 | 732 | 417 | 538 | 645 | 727 | 426 |
| After one year | 40 | 66 | 24 | 46 | 40 | 62 | 24 | 46 |
| | 571 | 717 | 756 | 463 | 578 | 707 | 751 | 472 |

(c) Included in interest and other receivables are debtors with the following ageing analysis :

| | KCRC Group | | | | Corporation | | | |
|---|---|---|---|---|---|---|---|---|
| | As at 31 December | | | As at 30 June | As at 31 December | | | As at 30 June |
| | 2006 | 2005 | 2004 | 2007 | 2006 | 2005 | 2004 | 2007 |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Current | 440 | 573 | 688 | 345 | 447 | 563 | 683 | 354 |
| Less than one month overdue | 2 | 3 | 6 | 6 | 2 | 3 | 6 | 6 |
| One to three months overdue | 3 | 3 | 17 | 1 | 3 | 3 | 17 | 1 |
| More than three months overdue | 1 | 5 | 2 | 2 | 1 | 5 | 2 | 2 |
| Total debtors | 446 | 584 | 713 | 354 | 453 | 574 | 708 | 363 |
| Deposits, prepayments and revenue in arrears | 125 | 133 | 43 | 109 | 125 | 133 | 43 | 109 |
| | 571 | 717 | 756 | 463 | 578 | 707 | 751 | 472 |

Normally, no credit is allowed except for revenue sharing arrangements in which the normal credit period is one month. For the amount due from the Government regarding the entrustment works undertaken by the Corporation on behalf of the Government, the normal credit period is 21 days pursuant to the respective entrustment agreements. As at 31 December 2006, 2005 and 2004 and 30 June 2007, specific allowances for doubtful debts of $4 million, $5 million, $8 million and $1 million, respectively, were recognised. The KCRC Group does not hold any collateral over these balances.

**25 Cash and cash equivalents**

Cash and cash equivalents comprise :

| | KCRC Group | | | | Corporation | | | |
|---|---|---|---|---|---|---|---|---|
| | As at 31 December | | | As at 30 June | As at 31 December | | | As at 30 June |
| | 2006 | 2005 | 2004 | 2007 | 2006 | 2005 | 2004 | 2007 |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Deposits with banks | | | | | | | | |
| — Within three months to maturity when placed | 1,405 | 1,797 | 2,555 | 264 | 1,337 | 1,673 | 2,450 | 190 |
| — More than three months to maturity when placed | 471 | 1,555 | 940 | 212 | 387 | 1,555 | 940 | 123 |
| Cash at bank and in hand | 71 | 42 | 36 | 69 | 71 | 42 | 36 | 69 |
| Cash and cash equivalents in the balance sheets | 1,947 | 3,394 | 3,531 | 545 | 1,795 | 3,270 | 3,426 | 382 |
| Less: deposits with banks with more than three months to maturity when placed | (471) | (1,555) | (940) | (212) | | | | |
| Cash and cash equivalents in the consolidated cash flow statement | 1,476 | 1,839 | 2,591 | 333 | | | | |

**26 Interest and other payables**

(a) Interest and other payables comprise:

| | KCRC Group | | | | Corporation | | | |
|---|---|---|---|---|---|---|---|---|
| | As at 31 December | | | As at 30 June | As at 31 December | | | As at 30 June |
| | **2006** | **2005** | **2004** | **2007** | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Interest payable | 462 | 486 | 485 | 444 | 462 | 470 | 468 | 444 |
| Deposits and advances | 1,151 | 1,075 | 1,173 | 1,127 | 998 | 954 | 1,085 | 967 |
| Creditors and accrued charges | 846 | 1,242 | 1,271 | 856 | 842 | 1,236 | 1,257 | 853 |
| Amounts due to subsidiaries | — | — | — | — | 5 | 4 | 1 | 4 |
| | 2,459 | 2,803 | 2,929 | 2,427 | 2,307 | 2,664 | 2,811 | 2,268 |

(b) Interest and other payables are expected to be settled as follows:

| | KCRC Group | | | | Corporation | | | |
|---|---|---|---|---|---|---|---|---|
| | As at 31 December | | | As at 30 June | As at 31 December | | | As at 30 June |
| | **2006** | **2005** | **2004** | **2007** | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Within one year | 1,697 | 2,132 | 2,054 | 1,981 | 1,570 | 1,993 | 1,936 | 1,819 |
| After one year | 762 | 671 | 875 | 446 | 737 | 671 | 875 | 449 |
| | 2,459 | 2,803 | 2,929 | 2,427 | 2,307 | 2,664 | 2,811 | 2,268 |

(c) Included in interest and other payables are creditors with the following ageing analysis:

| | KCRC Group | | | | Corporation | | | |
|---|---|---|---|---|---|---|---|---|
| | As at 31 December | | | As at 30 June | As at 31 December | | | As at 30 June |
| | **2006** | **2005** | **2004** | **2007** | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Due within one month or on demand | 557 | 641 | 706 | 528 | 558 | 645 | 698 | 528 |
| Due between one month to three months | 219 | 234 | 202 | 220 | 219 | 218 | 185 | 220 |
| Due between three months to six months | 43 | 45 | 45 | 7 | 43 | 45 | 45 | 7 |
| Due after six months | 199 | 255 | 313 | 161 | 199 | 255 | 313 | 161 |
| Total creditors | 1,018 | 1,175 | 1,266 | 916 | 1,019 | 1,163 | 1,241 | 916 |
| Deposits and advances | 1,151 | 1,075 | 1,173 | 1,127 | 998 | 954 | 1,085 | 968 |
| Accrued charges | 290 | 553 | 490 | 384 | 290 | 547 | 485 | 384 |
| | 2,459 | 2,803 | 2,929 | 2,427 | 2,307 | 2,664 | 2,811 | 2,268 |

**27 Accrued charges and provisions for capital projects**

The balance includes accrued charges and provisions for claims related to capital projects. Accrued charges will be settled upon certification of work done. Provisions for claims relate mainly to the West Rail, East Rail Extensions and Kowloon Southern Link projects.

The balances as at 31 December 2006, 2005 and 2004 and 30 June 2007 include an aggregate amount of $1,361 million, $1,584 million, $1,511 million and $1,360 million, respectively, payable to the Government mainly for land premium, resumption and associated costs in relation to the West Rail, East Rail Extensions, Shatin to Central Link and Kowloon Southern Link projects.

During the six months ended 30 June 2007, the Corporation made additional provisions for claims and land premium, resumption and associated costs of $71 million and reversed or utilised amounts totalling $185 million. As of 30 June 2007, provision for claims and land premium, resumption and associated costs totalled $1,346 million.

The KCRC Group and the Corporation

Accrued charges and provisions for capital projects are expected to be settled or utilised as follows:

| | **As at 31 December** | | | **As at 30 June** |
|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Within one year | 1,080 | 1,814 | 3,284 | 1,043 |
| After one year | 974 | 1,224 | 687 | 1,075 |
| | 2,054 | 3,038 | 3,971 | 2,118 |

**28 Lease payable**

The lease payable in 2004 and 2005 related to one of the lease arrangements entered into by the KCRC Group and the Corporation. Under such lease arrangement, the lease payable was to be funded by the interest earned on certain loans to a third party and the repayment of those loans. In 2006, the lease arrangement was terminated and the lease payable together with the termination amount payable by the KCRC Group and the Corporation were settled with the loans to the third party under the agreements for terminating the lease.

**29 Short-term bank loans and interest-bearing borrowings**

The KCRC Group and the Corporation

(a) Short-term bank loans and interest-bearing borrowings comprise:

| | As at 31 December | | | | | | As at 30 June | |
|---|---|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2004 | | 2007 | |
| | Carrying amount | Fair value | Carrying amount | Fair value | Carrying amount | Fair value | Carrying amount | Fair value |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| *Capital market instruments* | | | | | | | | |
| HK dollar retail notes due 2008 and 2013 - see (c) below | 963 | 1,010 | 989 | 989 | 1,020 | 1,043 | 968 | 974 |
| US dollar notes due 2010 - see (d) below | 7,779 | 8,323 | 7,753 | 8,522 | 7,785 | 8,998 | 7,822 | 8,232 |
| US dollar notes due 2009 - see (e) below | 7,866 | 8,078 | 7,856 | 8,231 | 7,771 | 8,654 | 7,891 | 8,031 |
| HK dollar notes due 2013 - see (e) below | 808 | 808 | 789 | 789 | 800 | 829 | 768 | 768 |
| US dollar notes due 2014 - see (e) below | 389 | 433 | 387 | 444 | 388 | 459 | 390 | 423 |
| | 17,805 | 18,652 | 17,774 | 18,975 | 17,764 | 19,983 | 17,839 | 18,428 |
| Export credit loans - see (f) below | 1,407 | 1,406 | 1,700 | 1,706 | 1,984 | 2,033 | — | — |
| Interest-bearing borrowings | 19,212 | 20,058 | 19,474 | 20,681 | 19,748 | 22,016 | 17,839 | 18,428 |
| Short-term bank loans - see (g) below | — | — | — | — | — | — | 1,013 | 1,013 |
| | 19,212 | 20,058 | 19,474 | 20,681 | 19,748 | 22,016 | 18,852 | 19,441 |

(b) The fair values of capital market instruments and export credit loans were determined using discounted cash flow techniques.

(c) The Corporation issued 3% notes due 2008 with an aggregate nominal value of HK$300 million at a premium and 4.8% notes due 2013 with an aggregate nominal value of HK$700 million at a premium on 6 June 2003. All the notes issued are unsecured and rank equally with all of the Corporation's other unsecured senior indebtedness.

(d) The Corporation issued 8% notes due 2010 with an aggregate nominal value of US$1 billion at a discount on 16 March 2000. These notes are registered with the United States Securities and Exchange Commission and listed on The Stock Exchange of Hong Kong Limited, the London Stock Exchange plc and the New York Stock Exchange, Inc. All the notes issued are unsecured and rank equally with all of the Corporation's other unsecured senior indebtedness.

(e) The Corporation issued 7.25% notes due 2009 with an aggregate nominal value of US$1 billion at a discount on 27 July 1999, 7.77% notes due 2014 with an aggregate nominal value of US$50 million at a discount on 17 November 1999, and 4.65% notes due 2013 with an aggregate nominal value of HK$800 million at par on 9 June 2003 under its US$3 billion medium term note programme. All the notes issued are unsecured and rank equally with all of the Corporation's other unsecured senior indebtedness.

(f) In April and May 2007, the Corporation fully repaid the export credit loan facility provided by Japan Bank for International Cooperation and Export Development Canada, respectively.

(g) As at 30 June 2007, short-term bank loans are unsecured, interest bearing at rates ranging 4.19% to 4.56% per annum and repayable within three months of the balance sheet date.

(h) The covenants attached to the Corporation's interest-bearing borrowings are customary ones. Following the repayment of the export credit loan provided by Japan Bank for International Cooperation, there are no specific financial covenants attached to the Corporation's interest-bearing borrowings.

(i) The interest-bearing borrowings were repayable as follows:

| | As at 31 December | | | As at 30 June |
|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** |
| | **Total** | **Total** | **Total** | **Total** |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Within one year | 305 | 299 | 299 | 295 |
| After one year but within two years | 600 | 304 | 300 | — |
| After two years but within five years | 16,431 | 16,817 | 8,991 | 15,713 |
| After five years | 1,876 | 2,054 | 10,158 | 1,831 |
| | 19,212 | 19,474 | 19,748 | 17,839 |

**30 Deferred income**

(a) The balance of deferred income includes cash received from property developers for property development sites along East Rail and Ma On Shan Rail, cash receipts arising from the lease out and lease back arrangements and cash received from the telecommunication operators for the leasing of telecommunication networks. The cash received from property developers will be utilised for costs to be incurred by the Corporation in respect of the relevant property development. The unutilised balance will be credited to income statement when the property enabling works are completed and accepted for development and after taking into account the outstanding risks and obligations in connection with the development, if any, retained by the Corporation. The balance relating to the lease out and lease back arrangements and telecommunication networks is amortised and credited to the income statement over the applicable lease terms. The gains arising from the difference between the initial fair value and the nominal value of rental security deposits are amortised and charged to the income statement over the relevant lease terms.

(b) Movements on deferred income comprise:

| | KCRC Group | | | | Corporation | | | |
|---|---|---|---|---|---|---|---|---|
| | Year ended 31 December | | | Six months ended 30 June | Year ended 31 December | | | Six months ended 30 June |
| | 2006 | 2005 | 2004 | 2007 | 2006 | 2005 | 2004 | 2007 |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance at 1 January | 541 | 708 | 743 | 527 | 501 | 663 | 707 | 492 |
| Net receipt/(payment) | 445 | 76 | 12 | (9) | 445 | 76 | — | (9) |
| Gains arising from the difference between the initial fair value and the nominal value of rental securities deposits | — | — | — | 74 | — | — | — | 74 |
| Provision for amount payable upon termination of a lease arrangement | — | (196) | — | — | — | (196) | — | — |
| Recognised in the income statement | (459) | (47) | (47) | (30) | (454) | (42) | (44) | (28) |
| Balance at 31 December/30 June | 527 | 541 | 708 | 562 | 492 | 501 | 663 | 529 |

(c) Deferred income is expected to be recognised in the income statement as follows:

| | KCRC Group | | | | Corporation | | | |
|---|---|---|---|---|---|---|---|---|
| | As at 31 December | | | As at 30 June | As at 31 December | | | As at 30 June |
| | 2006 | 2005 | 2004 | 2007 | 2006 | 2005 | 2004 | 2007 |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Within one year | 32 | 32 | 48 | 53 | 27 | 27 | 43 | 48 |
| After one year | 495 | 509 | 660 | 509 | 465 | 474 | 620 | 481 |
| | 527 | 541 | 708 | 562 | 492 | 501 | 663 | 529 |

## 31 Share capital

| | As at 31 December | | | | | | As at 30 June | |
|---|---|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2004 | | 2007 | |
| | *No. of shares* | *$ million* | *No. of shares* | *$ million* | *No. of shares* | *$ million* | *No. of shares* | *$ million* |
| **Share capital:** | | | | | | | | |
| **Authorised:** | | | | | | | | |
| Shares of $100,000 each | 425,000 | 42,500 | 425,000 | 42,500 | 425,000 | 42,500 | 425,000 | 42,500 |
| **Issued and fully paid:** | | | | | | | | |
| At 31 December/ 30 June | 391,200 | 39,120 | 391,200 | 39,120 | 391,200 | 39,120 | 391,200 | 39,120 |

**Capital management**

The Corporation's capital includes share capital and reserves.

The entire issued share capital of the Corporation is held by the Financial Secretary Incorporated.

The Corporation received HK$14.5 billion, HK$6.0 billion and HK$8.5 billion in April 1998, January 1999 and April 1999, respectively, constituting a total equity injection of HK$29.0 billion from the Government in connection with the development of the West Rail. In March 2001, the Corporation received HK$8.0 billion from the Government in connection with the development of the Tsim Sha Tsui Extension and the Ma On Shan Rail. Any further contributions of capital will be determined by the Government in consultation with the Corporation.

Pursuant to the relevant provisions of the Ordinance, the Corporation may declare dividends to the Government as its sole shareholder. The Financial Secretary may, after consultation with the Corporation and after taking into account the extent of its loans and other obligations, direct the Corporation to declare a dividend.

## 32 Reserves

The KCRC Group

| | Development reserve | Investments revaluation reserve | Retained profits | Total |
|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance at 1 January 2004 | 6,535 | (1) | 14,530 | 21,064 |
| Net deficit arising from revaluation | — | (54) | — | (54) |
| Net deficit transferred to the income statement on redemption and disposal | — | 39 | — | 39 |
| Dividend approved in respect of the previous year | — | — | (620) | (620) |
| Profit for the year | — | — | 513 | 513 |
| Balance at 31 December 2004 | 6,535 | (16) | 14,423 | 20,942 |
| Balance at 1 January 2005 | 6,535 | (16) | 14,423 | 20,942 |
| — opening balance adjustments arising from changes in accounting policies | — | — | (568) | (568) |
| — as restated | 6,535 | (16) | 13,855 | 20,374 |
| Transfer to retained profits | (6,535) | — | 6,535 | — |
| Net deficit arising from revaluation | — | (15) | — | (15) |
| Net deficit transferred to the income statement on redemption and disposal | — | 29 | — | 29 |
| Dividend approved in respect of the previous year | — | — | (172) | (172) |
| Profit for the year | — | — | 317 | 317 |
| Balance at 31 December 2005 | — | (2) | 20,535 | 20,533 |
| Balance at 1 January 2006 | — | (2) | 20,535 | 20,533 |
| Net deficit transferred to income statement on redemption and disposal | — | 2 | — | 2 |
| Profit for the year | — | — | 278 | 278 |
| Balance at 31 December 2006 | — | — | 20,813 | 20,813 |
| Balance at 1 January 2007 | — | — | 20,813 | 20,813 |
| Dividend approved in respect of the previous year | — | — | (82) | (82) |
| Profit for the period | — | — | 19 | 19 |
| Balance at 30 June 2007 | — | — | 20,750 | 20,750 |

The Corporation

| | Development reserve | Investments revaluation reserve | Retained profits | Total |
|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Balance at 1 January 2004 | 6,535 | (1) | 14,496 | 21,030 |
| Net deficit arising from revaluation | — | (54) | — | (54) |
| Net deficit transferred to the income statement on redemption and disposal | — | 39 | — | 39 |
| Dividend approved in respect of the previous year | — | — | (620) | (620) |
| Profit for the year | — | — | 502 | 502 |
| Balance at 31 December 2004 | 6,535 | (16) | 14,378 | 20,897 |
| Balance at 1 January 2005 | 6,535 | (16) | 14,378 | 20,897 |
| — opening balance adjustments arising from changes in accounting policies | — | — | (568) | (568) |
| — as restated | 6,535 | (16) | 13,810 | 20,329 |
| Transfer to retained profits | (6,535) | — | 6,535 | — |
| Net deficit arising from revaluation | — | (15) | — | (15) |
| Net deficit transferred to the income statement on redemption and disposal | — | 29 | — | 29 |
| Dividend approved in respect of the previous year | — | — | (172) | (172) |
| Profit for the year | — | — | 336 | 336 |
| Balance at 31 December 2005 | — | (2) | 20,509 | 20,507 |
| Balance at 1 January 2006 | — | (2) | 20,509 | 20,507 |
| Net deficit transferred to the income statement on redemption and disposal | — | 2 | — | 2 |
| Profit for the year | — | — | 252 | 252 |
| Balance at 31 December 2006 | — | — | 20,761 | 20,761 |
| Balance at 1 January 2007 | — | — | 20,761 | 20,761 |
| Dividend approved in respect of the previous year | — | — | (82) | (82) |
| Profit for the period | — | — | — | — |
| Balance at 30 June 2007 | — | — | 20,679 | 20,679 |

(a) Included in the retained profits of the Group as at 31 December 2006, 2005 and 2004 and 30 June 2007 are amounts of $57 million, $30 million, $48 million and $73 million, respectively, being the retained profits attributable to an associate.

(b) The development reserve represented appropriations of all profits from property developments prior to 2005 to retained reserves within the Corporation. The development reserve was created in accordance with the relevant provisions of the Ordinance.

In 2005, the balance of the development reserve was transferred to retained profits upon the approval from the Financial Secretary of the Government in accordance with the relevant provisions of the Ordinance.

(c) The fair value change of financial assets and liabilities and investment properties, net of related deferred tax, recognised in retained profits are not available for distribution to the sole shareholder because they are not realised profits of the Corporation. As at 31 December 2006, 2005 and 2004 and 30 June 2007, the amount of reserves available for distribution to the sole shareholder amounted to $20,720 million, $20,384 million, $14,143 million and $20,399 million, respectively.

(d) With effect from 1 January 2005 in order to comply with HKAS 32 and HKAS 39, the KCRC Group changed its accounting policies relating to financial assets and liabilities. Details of the changes are as follow:

(i) *Investments*

Prior to 1 January 2005, investments were classified as investments held for non-trading purposes and were stated at fair value with changes in fair value recognised in the investments revaluation reserve.

With effect from 1 January 2005, and in accordance with HKAS 39, all investments were classified as available-for-sale securities and carried at fair value. Changes in fair value of available-for-sale securities are recognised in investments revaluation reserve except to the extent that they are capitalised as being directly attributable to the acquisition, construction or production of an asset when necessarily takes a substantial period of time to get ready for its intended use. There was no financial effect of this change in accounting policy.

(ii) *Interest-bearing borrowings*

Prior to 1 January 2005, the discount/premium and ancillary costs arising from interest-bearing borrowings were amortised to the income statement on a straight-line basis.

With effect from 1 January 2005, and in accordance with HKAS 39, the discount/premium and ancillary costs arising from interest-bearing borrowings are amortised to the income statement using the effective interest rate.

(iii) *Derivative financial assets and liabilities*

Prior to 1 January 2005, derivative financial instruments entered into by management to hedge the interest rate risk and foreign currency risk of a recognised liability were recognised with reference to the timing of recognition of the corresponding hedged transaction. Derivative financial instruments entered into for the purpose of hedging the foreign currency risk of a recognised foreign currency liability were revalued at the balance sheet date at the exchange rates ruling at that date with the resultant gains and losses used to offset gains and losses resulting from currency fluctuations inherent in the underlying foreign currency liabilities.

With effect from 1 January 2005, and in accordance with HKAS 39, all derivative financial instruments entered into by the KCRC Group are stated at fair value. Changes in the fair value of derivative financial instruments designated as hedging instruments in a cash flow hedge are recognised directly in the income statement in the same period or periods during which the liability affects the income statement (such as when the interest income or expense is recognised).

Changes in fair value of derivative financial instruments designated as hedging instruments in a fair value hedge are recognised in the income statement. Changes in the fair value of derivative financial instruments which do not qualify as hedging instruments are recognised in the income statement.

(iv) *Effect of the changes in accounting policies*

The changes in accounting policies relating to accounting for investments in securities and derivative financial assets and liabilities were adopted by way of opening balance adjustments to certain reserves as at 1 January 2005. Comparative amounts have not been restated as this is prohibited by the transitional arrangements in HKAS 39.

## 33 Financial assets and liabilities

In the normal course of its business, the KCRC Group is exposed to a variety of financial risks: foreign exchange risk, interest rate risk, credit risk and liquidity risk. The KCRC Group uses derivative financial instruments to hedge certain risk exposures.

The Managing Board has approved policies in respect of foreign exchange risk, interest-rate risk, credit risk, use of derivative financial instruments and investment of surplus funds. As part of its risk management, the KCRC Group identifies and evaluates the financial risks and, where appropriate, hedges those risks in accordance with the policies established by the Managing Board.

The KCRC Group documents at the inception of each hedging transaction the relationship between the hedging instrument and hedged item, as well as its risk management objective and strategy for undertaking the transaction. The KCRC Group also documents its assessment, both at inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are effective in offsetting changes in fair values or cash flows of the hedged items.

### *(a) Credit risk*

The KCRC Group's credit risk is primarily attributable to its investment in debt securities, its deposits and over-the-counter derivative financial instruments entered into for hedging purposes.

The KCRC Group has no significant concentrations of credit risk. It has policies in place that limit the amount of credit exposure to any financial institution with which the KCRC Group has transactions. The KCRC Group can only invest in debt securities issued by or place deposits with financial institutions that meet the established credit rating or other criteria. Derivative counterparties are limited to high-credit-quality financial institutions. The exposures to these credit risks are monitored on an ongoing basis.

The maximum exposure to credit risk is represented by the carrying amount of each financial asset in the balance sheet.

| | **KCRC Group** | | | | **Corporation** | | | |
|---|---|---|---|---|---|---|---|---|
| | **As at 31 December** | | | **As at 30 June** | **As at 31 December** | | | **As at 30 June** |
| | **2006** | **2005** | **2004** | **2007** | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Loan to non-controlled subsidiary | 4,022 | 3,863 | 3,576 | 4,214 | 4,022 | 3,863 | 3,576 | 4,214 |
| Loan to third party | — | 684 | 733 | — | — | — | 16 | — |
| Investments | — | 449 | 4,323 | — | — | 449 | 4,323 | — |
| Interest rate swaps | 90 | 124 | # | 56 | 90 | 124 | # | 56 |
| Forward foreign exchange contracts | 2 | 5 | # | 14 | 2 | 5 | # | 14 |
| Interest and other receivables | 571 | 717 | 756 | 463 | 578 | 707 | 751 | 472 |
| | 4,685 | 5,842 | 9,388 | 4,747 | 4,692 | 5,148 | 8,666 | 4,756 |

\# In accordance with the transitional provisions of HKAS 39, adjustments to the balance sheet as at 31 December 2004 to reflect the fair values of derivative financial instruments held at that date are not required.

***(b) Interest rate risk***

(i) *Hedging*

The KCRC Group's interest rate risk arises from its long-term borrowings. Borrowings at variable rates expose the KCRC Group to cash flow interest rate risk. Borrowings at fixed rates expose the KCRC Group to fair value interest rate risk. The KCRC Group aims to maintain the proportion of its fixed rate borrowings at between 30% and 75% of total borrowings. At 30 June 2007, 70% of total borrowings were at fixed rates.

The KCRC Group enters into receive-fixed-pay-floating interest rate swaps to hedge the fair value interest rate risk arising from fixed rate borrowings as well as to achieve an appropriate mix of fixed and floating rate exposure.

At 1 January 2005, 31 December 2005 and 2006 and 30 June 2007, the KCRC Group had interest rate swaps with a notional contract amount of $3,361 million, $3,356 million, $800 million and $800 million, respectively, which qualify as fair value hedges. These interest rate swaps are stated at fair value with changes in fair value being recognised in the income statement to offset the effect of the gain or loss on the related hedged portion of interest-bearing borrowings.

The net fair value of interest rate swaps entered into by the KCRC Group at 1 January 2005, 31 December 2005 and 2006 and 30 June 2007 and recognised as net derivative financial assets or liabilities was $271 million (assets), $88 million (assets), $7 million (assets) and $34 million (liabilities), respectively, which comprises assets of $271 million, $124 million, $7 million and nil, respectively, and liabilities of nil, $36 million, nil and $34 million, respectively.

Occasionally, the KCRC Group manages its cash flow interest rate risk by using receive-floating-pay-fixed interest rate swaps. There were no such swaps outstanding as at 30 June 2007.

(ii) *Fair value through income statement*

For interest rate swaps where the hedging relationships do not qualify as fair value hedges, changes in their fair values are recognised in the income statement.

At 1 January 2005, 31 December 2005 and 2006 and 30 June 2007, the KCRC Group had such interest rate swaps with a notional contract amount of $781 million, $1,362 million, $3,927 million and $3,942 million, respectively, and net fair value recognised as net derivative financial assets or liabilities of $22 million (liabilities), $40 million (liabilities), $42 million (assets) and $24 million (liabilities), respectively, which comprises assets of nil, nil, $83 million and $56 million, respectively, and liabilities of $22 million, $40 million, $41 million and $80 million, respectively.

(iii) *Sensitivity analysis*

The sensitivity analysis below has been conducted assuming that changes in interest rates of +/- 100 basis points (bps) had occurred at the balance sheet date and such changes had been applied to stress-test the interest rate risk for both derivative and non-derivative financial instruments in existence at that date. The 100 basis point increase or decrease represents management's assessment of a reasonably possible change in interest rates over the period until the next balance sheet date. The analysis was performed on the same basis for each balance sheet date presented below.

Other than for currency swaps where the forward exchange rates are slightly changed by a parallel shift in the interest rates of the underlying currencies, all other variables, in particular spot foreign currency rates, remain constant.

The KCRC Group and the Corporation

| | As at 30 June | | As at 31 December | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 2007 | 2007 | 2006 | 2006 | 2005 | 2005 | 2004 | 2004 |
| | *$ million +100 bps* | *$ million - 100 bps* | *$ million +100 bps* | *$ million - 100 bps* | *$ million +100 bps* | *$ million - 100 bps* | *$ million +100 bps* | *$ million - 100 bps* |
| Loan to non-controlled subsidiary | 17 | (17) | 33 | (33) | 32 | (32) | 30 | (30) |
| Investments | — | — | — | — | 3 | (3) | 5 | (5) |
| Interest rate swaps | (109) | 114 | (128) | 135 | (157) | 167 | # | # |
| Currency swaps | 1 | (1) | 10 | (10) | 3 | (3) | # | # |
| Interest-bearing borrowings | 31 | (33) | 33 | (36) | 113 | (120) | (7) | 7 |
| | (60) | 63 | (52) | 56 | (6) | 9 | 28 | (28) |

\# In accordance with the transitional provisions of HKAS 39, adjustments to the balance sheet as at 31 December 2004 to reflect the fair values of derivative financial instruments held at that date are not required. As a result, the impact on the profit after taxation arising from the change in basis points become irrelevant insofar as the derivative financial instruments are not stated at fair value at 31 December 2004.

### *(c) Currency risk*

The KCRC Group derives its revenues almost entirely in Hong Kong dollars and is therefore exposed to foreign exchange risk arising only from borrowings, purchases, and capital expenditure payments in relation to the development of new railways that are denominated in foreign currencies.

The KCRC Group uses forward exchange contracts and currency swaps to hedge its foreign exchange risk. The KCRC Group's risk management policy is to hedge its foreign currency borrowings into either Hong Kong dollars or United States dollars and limit its exposure to United States dollars to no greater than 30% of its total borrowings. Any contract for purchases or capital expenditure denominated in foreign currencies and exceeding $10 million equivalent is required to be reported to KCRC Group Treasury, which uses forward contracts to hedge the related foreign currency risk as and when necessary.

The KCRC Group may have investments in debt securities and other financial assets from time to time. Where these investments are denominated in foreign currencies other than United States dollars or Hong Kong dollars, the KCRC Group hedges the exposure into either United States dollars or Hong Kong dollars.

(i) *Recognised assets and liabilities*

Changes in the fair value of currency swaps that economically hedge recognised monetary liabilities in foreign currencies are recognised in the income statement. The net fair value of currency swaps used by the KCRC Group as economic hedges of monetary assets and liabilities in foreign currencies at 1 January 2005, 31 December 2005 and 2006 and 30 June 2007 and recognised as derivative financial liabilities was $691 million, $283 million, $456 million and $125 million, respectively.

(ii) *Fair value through income statement*

Changes in the fair value of forward foreign exchange contracts for which no hedge accounting is applied are recognised in the income statement. The net fair value of forward foreign exchange contracts recognised as net derivative financial assets or liabilities at 1 January 2005, 31 December 2005 and 2006 and 30 June 2007 was $17 million (liabilities), $3 million (assets), $41 million (liabilities) and $40 million (liabilities), respectively, which comprises assets of $11 million, $5 million, $2 million and $14 million, respectively, and liabilities of $28 million, $2 million, $43 million and $54 million, respectively.

In respect of other receivables and other payables denominated in currencies other than the functional currency of the KCRC Group's operations, the KCRC Group ensures that the net exposure is kept to an acceptable level by buying or selling foreign currencies at spot or forward rates where necessary.

All the KCRC Group's borrowings are denominated in either Hong Kong dollars or United States dollars. Given this, management does not expect that there will be any significant currency risk associated with the KCRC Group's borrowings.

(iii) *Exposure to currency risk*

Based on the notional amounts of the financial assets and liabilities, the following table shows the KCRC Group's and the Corporation's exposure at the balance sheet date to currency risk arising from forecast transactions or recognised assets or liabilities denominated in a currency other than the functional currency of the KCRC Group.

The KCRC Group

| | Expressed in foreign currency | | | |
|---|---|---|---|---|
| | **US dollars** | **Euros** | **Japanese yen** | **Swiss francs** |
| | *million* | *million* | *million* | *million* |
| **2006** | | | | |
| - Interest and other receivables | 1 | — | — | — |
| - Cash and cash equivalents | 178 | 2 | 87 | 7 |
| - Currency swaps | 1,950 | — | — | — |
| - Forward foreign exchange contracts | 164 | 4 | 7,883 | — |
| - Interest and other payables | (56) | — | — | — |
| - Interest-bearing borrowings | (2,230) | — | — | — |
| Overall net exposure | 7 | 6 | 7,970 | 7 |
| **2005** | | | | |
| - Loans to third party | 88 | — | — | — |
| - Investments | 55 | — | — | — |
| - Interest and other receivables | 6 | — | — | — |
| - Cash and cash equivalents | 292 | 1 | — | 8 |
| - Currency swaps | 1,950 | — | — | — |
| - Forward foreign exchange contracts | 153 | 4 | 10 | — |
| - Interest and other payables | (87) | — | — | — |
| - Lease payable | (88) | — | — | — |
| - Interest-bearing borrowings | (2,268) | — | — | — |
| Overall net exposure | 101 | 5 | 10 | 8 |
| **2004** | | | | |
| - Loans to third party | 94 | — | — | — |
| - Investments | 302 | — | — | — |
| - Interest and other receivables | 6 | — | — | — |
| - Cash and cash equivalents | 416 | — | — | — |
| - Currency swaps | 1,950 | — | — | — |
| - Forward foreign exchange contracts | 322 | 5 | 98 | — |
| - Interest and other payables | (59) | — | — | — |
| - Lease payable | (92) | — | — | — |
| - Interest-bearing borrowings | (2,304) | — | — | — |
| Overall net exposure | 635 | 5 | 98 | — |
| **30 June 2007** | | | | |
| - Interest and other receivables | 2 | — | — | — |
| - Cash and cash equivalents | 19 | 4 | 237 | 7 |
| - Currency swaps | 1,950 | — | — | — |
| - Forward foreign exchange contracts | 192 | 1 | 6,543 | — |
| - Interest and other payables | (56) | — | — | — |
| - Interest-bearing borrowings | (2,050) | — | — | — |
| Overall net exposure | 57 | 5 | 6,780 | 7 |

The Corporation

| | Expressed in foreign currency | | | |
|---|---|---|---|---|
| | US dollars | Euros | Japanese yen | Swiss francs |
| | *million* | *million* | *million* | *million* |
| **2006** | | | | |
| - Interest and other receivables | 1 | — | — | — |
| - Cash and cash equivalents | 178 | 2 | 87 | 7 |
| - Currency swaps | 1,950 | — | — | — |
| - Forward foreign exchange contracts | 164 | 4 | 7,883 | — |
| - Interest and other payables | (56) | — | — | — |
| - Interest-bearing borrowings | (2,230) | — | — | — |
| Overall net exposure | 7 | 6 | 7,970 | 7 |
| **2005** | | | | |
| - Investments | 55 | — | — | — |
| - Interest and other receivables | 4 | — | — | — |
| - Cash and cash equivalents | 292 | 1 | — | 8 |
| - Currency swaps | 1,950 | — | — | — |
| - Forward foreign exchange contracts | 153 | 4 | 10 | — |
| - Interest and other payables | (85) | — | — | — |
| - Interest-bearing borrowings | (2,268) | — | — | — |
| Overall net exposure | 101 | 5 | 10 | 8 |
| **2004** | | | | |
| - Loans to third party | 2 | — | — | — |
| - Investments | 302 | — | — | — |
| - Interest and other receivables | 4 | — | — | — |
| - Cash and cash equivalents | 416 | — | — | — |
| - Currency swaps | 1,950 | — | — | — |
| - Forward foreign exchange contracts | 322 | 5 | 98 | — |
| - Interest and other payables | (57) | — | — | — |
| - Interest-bearing borrowings | (2,304) | — | — | — |
| Overall net exposure | 635 | 5 | 98 | — |
| **30 June 2007** | | | | |
| - Interest and other receivables | 2 | — | — | — |
| - Cash and cash equivalents | 19 | 4 | 237 | 7 |
| - Currency swaps | 1,950 | — | — | — |
| - Forward foreign exchange contracts | 192 | 1 | 6,543 | — |
| - Interest and other payables | (56) | — | — | — |
| - Interest-bearing borrowings | (2,050) | — | — | — |
| Overall net exposure | 57 | 5 | 6,780 | 7 |

(iv) *Sensitivity analysis*

The following table indicates the approximate change in the KCRC Group's profit after taxation in response to reasonably possible changes in the foreign exchange rates to which the KCRC Group and the Corporation have exposure at the balance sheet date. Such exposure relates to the portion of US$ borrowings which is unhedged, and other assets and liabilities, such as deposits and future contract payments, denominated in foreign currencies.

| | | As at 31 December | | | As at 30 June |
|---|---|---|---|---|---|
| | | 2006 | 2005 | 2004 | 2007 |
| | Increase/ (decrease) in foreign exchange rate | Increase/ (decrease) in profit after taxation | Increase/ (decrease) in profit after taxation | Increase/ (decrease) in profit after taxation | Increase/ (decrease) in profit after taxation |
| | | *$ million* | *$ million* | *$ million* | *$ million* |
| US dollars | 1% | (31) | (29) | 48 | (13) |
| | (1%) | 31 | 29 | (48) | 13 |
| Euros | 10% | 5 | 4 | — | 5 |
| | (10%) | (5) | (4) | — | (5) |
| Japanese yen | 10% | 42 | — | — | 35 |
| | (10%) | (42) | — | — | (35) |
| Swiss francs | 10% | 4 | 4 | — | 4 |
| | (10%) | (4) | (4) | — | (4) |

The sensitivity analysis has been determined assuming that reasonably possible changes in foreign exchange rates had occurred at the balance sheet date and had been applied to each of the KCRC Group's exposures to currency risk for both derivative and non-derivative financial instruments in existence at that date, and that all other variables, in particular interest rates, remain constant. The stated changes represent management's assessment of reasonably possible changes in foreign exchange rates over the period until the next balance sheet date. Results of the analysis as presented in the table above represent an aggregation of the effects of the KCRC Group's profit after taxation measured in the respective functional currencies, translated into Hong Kong dollars at exchange rates, based on direct quotes, prevailing at the balance sheet date for presentation purposes. The analysis was performed on the same basis for each accounting period presented above.

***(d) Liquidity risk***

Liquidity risk represents the KCRC Group's ability to meet its contractual obligations. The KCRC Group evaluates its liquidity requirements on an ongoing basis. It employs projected cash flow analyses to forecast the future funding requirements.The KCRC Group's approach to managing liquidity is to ensure there will be sufficient liquidity to meet its liabilities when they fall due, under both normal and stressed conditions.

The KCRC Group aims to secure committed credit facilities well ahead of funding needs. This protects the KCRC Group against adverse market conditions which may result in difficulties in raising funds to meet payment obligations. The KCRC Group has put in place committed revolving facilities and uncommitted stand-by facilities to cater for short-term liquidity requirements.

The following table shows the time periods after the balance sheet date during which contractual payments, presented on an undiscounted basis, are due to be made. These payments include, inter alia, interest payments computed using contractual rates (for fixed rate instruments) and rates prevalent at the balance sheet date (for floating rate instruments), in respect of the KCRC Group's and the Corporation's non-derivative and derivative financial liabilities which are due to be paid.

The KCRC Group

| | Carrying amount $ million | Total contractual cash flows $ million | Within 1 year or on demand $ million | More than 1 year but less than 2 years $ million | More than 2 years but less than 5 years $ million | More than 5 years $ million |
|---|---|---|---|---|---|---|
| **2006** | | | | | | |
| Interest and other payables | 2,459 | (2,467) | (1,823) | (167) | (332) | (145) |
| Interest rate swaps | 41 | (50) | (19) | (13) | (18) | — |
| Currency swaps | | | | | | |
| - outflow | 456 | (15,512) | (102) | (103) | (14,914) | (393) |
| - inflow | — | 15,218 | — | — | 14,828 | 390 |
| Forward foreign exchange contracts | | | | | | |
| - outflow | 43 | (1,880) | (1,064) | (791) | (25) | — |
| - inflow | (2) | 1,846 | 1,053 | 770 | 23 | — |
| Interest-bearing borrowings | 19,212 | (24,029) | (1,680) | (1,958) | (18,265) | (2,126) |
| | 22,209 | (26,874) | (3,635) | (2,262) | (18,703) | (2,274) |
| **2005** | | | | | | |
| Interest and other payables | 2,803 | (2,832) | (2,145) | (301) | (383) | (3) |
| Interest rate swaps | 76 | (63) | (16) | (16) | (37) | 6 |
| Currency swaps | | | | | | |
| - outflow | 283 | (15,614) | (102) | (102) | (15,015) | (395) |
| - inflow | — | 15,177 | — | — | 14,788 | 389 |
| Forward foreign exchange contracts | | | | | | |
| - outflow | 2 | (1,224) | (1,210) | (14) | — | — |
| - inflow | (5) | 1,232 | 1,219 | 13 | — | — |
| Lease payable | 684 | (684) | (34) | (36) | (124) | (490) |
| Interest-bearing borrowings | 19,474 | (25,654) | (1,685) | (1,674) | (19,892) | (2,403) |
| | 23,317 | (29,662) | (3,973) | (2,130) | (20,663) | (2,896) |
| **2004** | | | | | | |
| Interest and other payables | 2,929 | (2,969) | (2,094) | (160) | (652) | (63) |
| Interest rate swaps | # | (24) | 3 | (2) | (20) | (5) |
| Currency swaps | | | | | | |
| - outflow | # | (15,716) | (102) | (102) | (8,083) | (7,429) |
| - inflow | # | 15,225 | — | — | 7,808 | 7,417 |
| Forward foreign exchange contracts | | | | | | |
| - outflow | # | (2,541) | (1,355) | (1,186) | — | — |
| - inflow | # | 2,576 | 1,373 | 1,203 | — | — |
| Lease payable | 717 | (717) | (31) | (34) | (116) | (536) |
| Interest-bearing borrowings | 19,748 | (27,390) | (1,687) | (1,685) | (13,071) | (10,947) |
| | 23,394 | (31,556) | (3,893) | (1,966) | (14,134) | (11,563) |
| **30 June 2007** | | | | | | |
| Short-term bank loans | 1,013 | (1,024) | (1,024) | — | — | — |
| Interest and other payables | 2,427 | (2,502) | (2,017) | (151) | (332) | (2) |
| Interest rate swaps | 114 | (131) | (29) | (26) | (60) | (16) |
| Currency swaps | | | | | | |
| - outflow | 125 | (15,461) | (102) | (102) | (14,864) | (393) |
| - inflow | — | 15,300 | — | — | 14,908 | 392 |
| Forward foreign exchange contracts | | | | | | |
| - outflow | 54 | (1,966) | (1,424) | (539) | (3) | — |
| - inflow | (14) | 1,935 | 1,392 | 540 | 3 | — |
| Interest-bearing borrowings | 17,839 | (21,853) | (1,607) | (1,298) | (16,909) | (2,039) |
| | 21,558 | (25,702) | (4,811) | (1,576) | (17,257) | (2,058) |

\# In accordance with the transitional provisions of HKAS 39, adjustments to the balance sheet as at 31 December 2004 to reflect the fair values of derivative financial instruments held at that date are not required.

The Corporation

| | Carrying amount | Total contractual cash flows | Within 1 year or on demand | More than 1 year but less than 2 years | More than 2 years but less than 5 years | More than 5 years |
|---|---|---|---|---|---|---|
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| **2006** | | | | | | |
| Interest and other payables | 2,307 | (2,315) | (1,671) | (167) | (332) | (145) |
| Interest rate swaps | 41 | (50) | (19) | (13) | (18) | — |
| Currency swaps | | | | | | |
| - outflow | 456 | (15,512) | (102) | (103) | (14,914) | (393) |
| - inflow | — | 15,218 | — | — | 14,828 | 390 |
| Forward foreign exchange contracts | | | | | | |
| - outflow | 43 | (1,880) | (1,064) | (791) | (25) | — |
| - inflow | (2) | 1,846 | 1,053 | 770 | 23 | — |
| Interest-bearing borrowings | 19,212 | (24,029) | (1,680) | (1,958) | (18,265) | (2,126) |
| | 22,057 | (26,722) | (3,483) | (2,262) | (18,703) | (2,274) |
| **2005** | | | | | | |
| Interest and other payables | 2,664 | (2,693) | (2,006) | (301) | (383) | (3) |
| Interest rate swaps | 76 | (63) | (16) | (16) | (37) | 6 |
| Currency swaps | | | | | | |
| - outflow | 283 | (15,614) | (102) | (102) | (15,015) | (395) |
| - inflow | — | 15,177 | — | — | 14,788 | 389 |
| Forward foreign exchange contracts | | | | | | |
| - outflow | 2 | (1,224) | (1,210) | (14) | — | — |
| - inflow | (5) | 1,232 | 1,219 | 13 | — | — |
| Interest-bearing borrowings | 19,474 | (25,654) | (1,685) | (1,674) | (19,892) | (2,403) |
| | 22,494 | (28,839) | (3,800) | (2,094) | (20,539) | (2,406) |
| **2004** | | | | | | |
| Interest and other payables | 2,811 | (2,851) | (1,976) | (160) | (652) | (63) |
| Interest rate swaps | # | (24) | 3 | (2) | (20) | (5) |
| Currency swaps | | | | | | |
| - outflow | # | (15,716) | (102) | (102) | (8,083) | (7,429) |
| - inflow | # | 15,225 | — | — | 7,808 | 7,417 |
| Forward foreign exchange contracts | | | | | | |
| - outflow | # | (2,541) | (1,355) | (1,186) | — | — |
| - inflow | # | 2,576 | 1,373 | 1,203 | — | — |
| Interest-bearing borrowings | 19,748 | (27,390) | (1,687) | (1,685) | (13,071) | (10,947) |
| | 22,559 | (30,721) | (3,744) | (1,932) | (14,018) | (11,027) |
| **30 June 2007** | | | | | | |
| Short-term bank loans | 1,013 | (1,024) | (1,024) | — | — | — |
| Interest and other payables | 2,268 | (2,665) | (2,180) | (151) | (332) | (2) |
| Interest rate swaps | 114 | (131) | (29) | (26) | (60) | (16) |
| Currency swaps | | | | | | |
| - outflow | 125 | (15,461) | (102) | (102) | (14,864) | (393) |
| - inflow | — | 15,300 | — | — | 14,908 | 392 |
| Forward foreign exchange contracts | | | | | | |
| - outflow | 54 | (1,966) | (1,424) | (539) | (3) | — |
| - inflow | (14) | 1,935 | 1,392 | 540 | 3 | — |
| Interest-bearing borrowings | 17,839 | (21,853) | (1,607) | (1,298) | (16,909) | (2,039) |
| | 21,399 | (25,865) | (4,974) | (1,576) | (17,257) | (2,058) |

# In accordance with the transitional provisions of HKAS 39, adjustments to the balance sheet as at 31 December 2004 to reflect the fair values of derivative financial instruments held at that date are not required.

*(e)* ***Fair value***

The fair values of all financial assets and liabilities are set out in the following tables except for those financial assets and liabilities with carrying amounts not materially different from their fair values at the balance sheet date.

The KCRC Group

| | As at 31 December | | | | | | As at 30 June | |
|---|---|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2004 | | 2007 | |
| | Carrying amount | Fair value | Carrying amount | Fair value | Carrying amount | Fair value | Carrying amount | Fair value |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Non-derivative financial assets | | | | | | | | |
| - Loans to third party | — | — | 684 | 668 | 733 | 732 | — | — |
| - Loan to non-controlled subsidiary | 4,022 | 4,468 | 3,863 | 4,105 | 3,576 | 3,939 | 4,214 | 4,523 |
| - Investments | — | — | 449 | 449 | 4,323 | 4,323 | — | — |
| | 4,022 | 4,468 | 4,996 | 5,222 | 8,632 | 8,994 | 4,214 | 4,523 |
| Derivative financial assets | | | | | | | | |
| - Interest rate swaps | 90 | 90 | 124 | 124 | # | 271 | 56 | 56 |
| - Forward foreign exchange contracts | 2 | 2 | 5 | 5 | # | 11 | 14 | 14 |
| | 92 | 92 | 129 | 129 | # | 282 | 70 | 70 |
| Non-derivative financial liabilities | | | | | | | | |
| - Short-term bank loans | — | — | — | — | — | — | (1,013) | (1,013) |
| - Lease payable | — | — | (684) | (668) | (717) | (715) | — | — |
| - Interest-bearing borrowings | (19,212) | (20,058) | (19,474) | (20,681) | (19,748) | (22,016) | (17,839) | (18,428) |
| | (19,212) | (20,058) | (20,158) | (21,349) | (20,465) | (22,731) | (18,852) | (19,441) |
| Derivative financial liabilities | | | | | | | | |
| - Interest rate swaps | (41) | (41) | (76) | (76) | # | (22) | (114) | (114) |
| - Currency swaps | (456) | (456) | (283) | (283) | # | (691) | (125) | (125) |
| - Forward foreign exchange contracts | (43) | (43) | (2) | (2) | # | (28) | (54) | (54) |
| | (540) | (540) | (361) | (361) | # | (741) | (293) | (293) |

\# In accordance with the transitional provisions of HKAS 39, adjustments to the balance sheet as at 31 December 2004 to reflect the fair values of derivative financial instruments held at that date are not required.

The Corporation

| | As at 31 December | | | | | | As at 30 June | |
|---|---|---|---|---|---|---|---|---|
| | 2006 | | 2005 | | 2004 | | 2007 | |
| | Carrying amount | Fair value | Carrying amount | Fair value | Carrying amount | Fair value | Carrying amount | Fair value |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* | *$ million* |
| Non-derivative financial assets | | | | | | | | |
| - Loans to third party | — | — | — | — | 16 | 17 | — | — |
| - Loan to non-controlled subsidiary | 4,022 | 4,468 | 3,863 | 4,105 | 3,576 | 3,939 | 4,214 | 4,523 |
| - Investments | — | — | 449 | 449 | 4,323 | 4,323 | — | — |
| | 4,022 | 4,468 | 4,312 | 4,554 | 7,915 | 8,279 | 4,214 | 4,523 |
| Derivative financial assets | | | | | | | | |
| - Interest rate swaps | 90 | 90 | 124 | 124 | # | 271 | 56 | 56 |
| - Forward foreign exchange contracts | 2 | 2 | 5 | 5 | # | 11 | 14 | 14 |
| | 92 | 92 | 129 | 129 | # | 282 | 70 | 70 |
| Non-derivative financial liabilities | | | | | | | | |
| - Short-term bank loans | — | — | — | — | — | — | (1,013) | (1,013) |
| - Interest-bearing borrowings | (19,212) | (20,058) | (19,474) | (20,681) | (19,748) | (22,016) | (17,839) | (18,428) |
| | (19,212) | (20,058) | (19,474) | (20,681) | (19,748) | (22,016) | (18,852) | (19,441) |
| Derivative financial liabilities | | | | | | | | |
| - Interest rate swaps | (41) | (41) | (76) | (76) | # | (22) | (114) | (114) |
| - Currency swaps | (456) | (456) | (283) | (283) | # | (691) | (125) | (125) |
| - Forward foreign exchange contracts | (43) | (43) | (2) | (2) | # | (28) | (54) | (54) |
| | (540) | (540) | (361) | (361) | # | (741) | (293) | (293) |

\# In accordance with the transitional provisions of HKAS 39, adjustments to the balance sheet as at 31 December 2004 to reflect the fair values of derivative financial instruments held at that date are not required.

***(f) Estimation of fair value***

The following summarises the major methods and assumptions used in estimating the fair values of financial assets and liabilities reflected in the tables set out in note 33(e) above.

(i) *Investments*

The fair value of financial assets traded in active markets was based on quoted market prices at the balance sheet date.

(ii) *Interest rate swaps, currency swaps and forward exchange contracts*

The fair value of interest rate swaps and currency swaps was based on the present value of the estimated amount that the KCRC Group would receive or pay to terminate the swap at the balance sheet date, taking into account prevailing interest rates, foreign exchange rates and creditworthiness of the swap counterparties. The fair value of forward exchange contracts was based on the quoted market price at the balance sheet date, being the present value of the quoted forward price. Discounted cash flows techniques were used in determining the fair value of swaps.

(iii) *Loan to non-controlled subsidiary and interest-bearing borrowings*

Where applicable, fair value was calculated based on discounted cash flows of expected future principal and interest payments.

(iv) *Loans to third party and lease payable*

The fair value was estimated based on the present value of future cash flows.

(v) *Discount rates used for determining fair value*

The Corporation used the applicable yield curve at the balance sheet date plus an adequate constant credit spread to discount financial assets and liabilities. The interest rates used were as follows:

| | **As at 31 December** | | | **As at 30 June** |
|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** |
| Interest rate swaps, currency swaps | 3.99% - 5.54% | 4.22% - 5.43% | 0.32% - 4.56% | 4.58% - 5.80% |
| Loan to non-controlled subsidiary and interest-bearing borrowings | 3.69% - 6.39% | 4.05% - 5.82% | 0.22% - 5.68% | 4.30% - 6.56% |
| Loans to third party and lease payable | — | 7.43% - 7.83% | 5.35% - 7.97% | — |

## 34 Notes to the consolidated cash flow statement

Reconciliation of operating profit after depreciation and amortisation to net cash inflow from operations

| | **Year ended 31 December** | | | **Six months ended 30 June** | |
|---|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** | **2006** |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million (unaudited)* |
| Operating profit after depreciation and amortisation | 292 | 98 | 491 | 154 | 125 |
| Depreciation and amortisation | 2,288 | 2,258 | 1,681 | 1,153 | 1,137 |
| Fixed assets written off | 24 | 43 | 24 | 19 | 11 |
| Increase in stores and spares | (19) | (24) | (65) | (5) | (36) |
| Decrease/(Increase) in other receivables | 210 | 194 | (262) | 136 | 197 |
| Increase/(Decrease) in other payables and deferred income | (131) | (177) | 440 | 38 | (79) |
| Decrease in loans to third party | — | 16 | — | — | — |
| Net cash inflow from operations | 2,664 | 2,408 | 2,309 | 1,495 | 1,355 |

## 35 Related parties

The Corporation is wholly owned by the Government. The Corporation has entered into transactions with the Government in respect of the developments of the West Rail, Phase I route, East Rail Extensions and Kowloon Southern Link which are considered to be related party transactions under HKAS 24 and these are disclosed in notes 1, 2(c), 6, 14(j), 15(c), (d) and (e), 16(a) and (b), 17, 18, 21, 24, 27 and 31 to the financial statements. Transactions with Government departments and agencies in the course of their normal dealings with the Corporation are not considered to be related party transactions.

Members of the Managing Board, the Executive Directors who are not Members of the Managing Board, members of the Management Committee and parties related to them are also related parties of the Corporation. During the years end 31 December 2006, 2005 and 2004 and the six months ended 30 June 2007 there were no significant transactions with any such parties other than their remuneration which is disclosed in note 6 to the financial statements.

Major related party transactions entered into by the KCRC Group in prior years which are still relevant for the current year comprise:

(i) On 15 September 1998, the Government approved the construction of West Rail, Phase I to be undertaken by the Corporation. The West Rail Project Agreement, which set out how the project was to be undertaken and the respective obligations of the Government and the Corporation in terms of the financing, design, construction and operation of West Rail, Phase I, was signed on 23 October 1998. On 24 February 2000, the Corporation and the Government entered into a shareholding agreement for undertaking all property developments along the West Rail, Phase I route (note 21).

(ii) The Corporation entered into a project agreement for the East Rail Extensions with the Government in 28 February 2003. The project agreement provided for the financing, design, construction and operations of the East Rail Extensions and related services and facilities.

(iii) The Corporation entered into a project agreement for the financing, design, construction and operation of Kowloon Southern Link with the Government on 6 October 2005. Under the terms of the KSL Project Agreement, the Corporation will be responsible for, and will finance the entire capital cost of constructing the Kowloon Southern Link, along with the costs of the removal, replacement, modification or improvement of existing facilities affected by or required as a consequence of the construction of the Kowloon Southern Link.

(iv) The Corporation accepted an offer from the Government to allow the Corporation to proceed with the development of the site at Ho Tung Lau and Wu Kai Sha in March 2003 and October 2005 respectively.

During the period, the KCRC Group entered into the following material related party transactions:

(i) In the construction of the new railway projects, certain essential project works are embedded within the infrastructure works to be undertaken by the Government or its related parties. The Government and its related parties have entered into entrustment agreements and certain services agreements with the Corporation under which the Corporation has agreed to carry out works on behalf of the Government and provide operational services such as maintenance and building management services. The works done and services provided by the Corporation are reimbursable and the details of amounts payable and receivable as at 30 June 2007 are contained in notes 15 and 24 respectively of this section of this Circular.

(ii) Octopus Cards Limited earned fees for the use of the Octopus cards system from the Corporation and paid ticket loading agent fees, handling fees and interest to the Corporation. Further details of the transactions are contained in note 19 of this section of this Circular.

**36 Outstanding commitments**

(a) Commitments outstanding in respect of capital expenditure not provided for in the financial statements were as follows:

| | As at 31 December | | | As at 30 June |
|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| *Investment properties* | | | | |
| — authorised and contracted for | 2 | 41 | 1 | 2 |
| — authorised but not contracted for | 2 | 7 | 51 | 2 |
| Property, plant and equipment | | | | |
| — authorised and contracted for | 3,860 | 4,093 | 2,601 | 3,143 |
| — authorised but not contracted for | 3,784 | 3,778 | 1,964 | 3,728 |
| Interest in leasehold land held for own use under operating leases | | | | |
| — authorised and contracted for | 219 | 291 | 349 | 194 |
| — authorised but not contracted for | 38 | 30 | — | 33 |
| Balance at 31 December/30 June | 7,905 | 8,240 | 4,966 | 7,102 |

(b) The total future minimum lease payments under non-cancellable operating leases for property with varying terms and renewal rights are payable as follows:

| | As at 31 December | | | As at 30 June |
|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Within one year | 38 | 46 | 40 | 42 |
| After one year but within five years | 49 | 94 | 18 | 31 |
| Balance at 31 December/30 June | 87 | 140 | 58 | 73 |

The operating leases are mainly related to work areas used for construction of new railways. During the years ended 31 December 2006, 2005 and 2004 and the six months ended 30 June 2007, amounts payable under operating leases totalling $46 million, $22 million, $54 million and $17 million, respectively, were capitalised as part of construction in progress or deferred expenditure, as appropriate.

**37 Retirement benefit scheme**

The Kowloon-Canton Railway Corporation Retirement Benefit Scheme ("RBS Scheme") was established on 1 February 1983 under trust. With effect from 16 November 1994, the RBS Scheme has been registered under Section 18 of the Occupational Retirement Schemes Ordinance.

All benefits payable under the RBS Scheme are calculated by reference to the Corporation's contributions and members' own contributions, together with investment returns on these contributions.

For members joining the RBS Scheme before 1 January 2000, the Corporation's contribution rates are 12% and 16% of the respective salaries of non-management staff and management staff. For members joining on or after 1 January 2000, the Corporation's contribution rates for the first eight years are 8% and 12% of the respective salaries of non-management staff and management staff and, thereafter, the contribution rates will be 10% and 15% of the respective salaries of non-management staff and management staff.

Where employees leave the RBS Scheme prior to their entitlement to all or part of the Corporation's contributions vesting fully, such contributions shall be used to reduce the future contributions of the Corporation due under the RBS Scheme.

The KCRC Group also operates a Mandatory Provident Fund Scheme ("MPF Scheme") under the Hong Kong Mandatory Provident Fund Schemes Ordinance. The MPF Scheme is a defined contribution retirement plan administrated by independent trustees. Under the MPF Scheme, the employer and its employees are each required to make contributions to the plan at 5% of the employees' relevant income, subject to a cap of monthly relevant income of $20,000. The MPF Scheme was introduced on 1 April 2000 to employees who did not opt for or who were not eligible for RBS Scheme.

The KCRC Group's total retirement cost charged to the income statement includes the retirement costs for both RBS and MPF Schemes.

**38 Debt facilities and programmes**

(a) Total debt facilities and programmes comprise:

| | As at 31 December | | | As at 30 June |
|---|---|---|---|---|
| | **2006** | **2005** | **2004** | **2007** |
| | *HK$ million* | *HK$ million* | *HK$ million* | *HK$ million* |
| **In HK dollars** | | | | |
| Short-term uncommitted revolving credit facilities | 2,200 | 2,200 | 1,650 | 2,300 |
| Letters of credit | 20 | 20 | 20 | 20 |
| Overdraft facilities | 25 | 25 | 25 | 25 |
| Syndicated loan facilities | 8,000 | 8,000 | 8,000 | 8,000 |
| | 10,245 | 10,245 | 9,695 | 10,345 |
| | *US$ million* | *US$ million* | *US$ million* | *US$ million* |
| **In US dollars** | | | | |
| Medium term note programme | 3,000 | 3,000 | 3,000 | 3,000 |
| Letters of credit for leveraged leases | 292 | 292 | 292 | 292 |
| Export credit loan facilities | 182 | 220 | 258 | — |
| | 3,474 | 3,512 | 3,550 | 3,292 |

(b) Total unutilised debt facilities and programmes available to the Corporation comprise:

| | As at 31 December | | | As at 30 June |
|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2007 |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Short-term uncommitted revolving credit facilities | 2,200 | 2,200 | 1,650 | 1,287 |
| Letters of credit | 20 | 20 | 20 | 20 |
| Overdraft facilities | 25 | 25 | 25 | 25 |
| Syndicated loan facilities | 8,000 | 8,000 | 8,000 | 8,000 |
| Medium term note programme | 14,418 | 14,377 | 14,425 | 14,501 |
| Letters of credit for leveraged leases | 2,279 | 2,273 | 2,280 | 2,291 |
| Export credit loan facilities | 10 | 11 | 29 | — |
| | 26,952 | 26,906 | 26,429 | 26,124 |

(c) The unutilised debt facilities are expected to expire as follows:

| | As at 31 December | | | As at 30 June |
|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2007 |
| | *$ million* | *$ million* | *$ million* | *$ million* |
| Floating rate | | | | |
| — expiring within one year | 2,620 | 2,245 | 2,624 | 1,709 |
| — expiring after one year | 9,914 | 10,284 | 9,380 | 9,914 |
| Fixed/floating rate to be determined when issued | | | | |
| — expiring after one year | 14,418 | 14,377 | 14,425 | 14,501 |
| | 26,952 | 26,906 | 26,429 | 26,124 |

## 39 Contingent liabilities

At 30 June 2007, the KCRC Group had contingent liabilities arising from the land resumption claims and certain contractors' claims in respect of the construction of the Kowloon Southern Link, West Rail and East Rail Extensions projects where the KCRC Group's total obligations cannot be estimated reliably. The KCRC Group has made provision in the financial statements at 30 June 2007 for its best estimate of amounts which are likely to be payable in connection with these claims. The amounts payable upon resolution of the claims may be eventually in excess of amounts estimated by the KCRC Group and accounted for in the financial statements at 30 June 2007. The KCRC Group is in the process of resolving these claims.

## 40 Impairment of assets

At 30 June 2007, the KCRC Group assessed whether there was any impairment of the KCRC Group's fixed assets at that date in accordance with the KCRC Group's accounting policies for the assessment of asset impairment.

In assessing the value in use of the KCRC Group's railway assets, the entire railway network, current and committed, has been treated as representing the smallest cash-generating unit on the basis that once the Kowloon Southern Link ("KSL") is completed in 2009, the current East Rail and West Rail networks will be linked and it will not be possible to allocate passenger revenue to any specific part of the network.

The estimated cash flows of the railway network were calculated for a period consistent with the estimated useful lives of the core assets of the railway network and were discounted using the Corporation's weighted average cost of capital at 30 June 2007.

The cash flows of the railway network were estimated on the basis that no Rail Merger with MTRCL will occur as HKAS 36 requires that the cash flows shall exclude those cash flows arising from future uncommitted restructurings.

As a result of this assessment, management considers that the railway assets of the KCRC Group are not impaired at 30 June 2007 and, accordingly, that no provision for impairment of the KCRC Group's railway assets is required at that date.

## 41 Comparative figures

As a result of adopting HKFRS 7, Financial instruments: Disclosures, and the amendments to HKAS 1, Presentation of financial statements: capital disclosures, certain comparative figures have been adjusted to conform with changes in disclosures in the current period and to show separately comparative amounts in respect of items disclosed for the first time in 2007. Further details of these developments are disclosed in note 3.

## 42 Accounting estimates and judgements

### *(a) Key sources of estimation uncertainty*

Note 33 contains information about the assumptions and their risk factors relating to financial instruments. Other key sources of estimation uncertainty include the assessment of useful lives for depreciation of fixed assets (see note 2(j)), assessment of provisions and contingent liabilities (see notes 2(aa), 27 and 39), determination of the recoverability of deferred tax assets (see note 10(d)), the valuation of investment properties (see note 14(f)), assessment of the possibility of implementation of Shatin to Central Link project (see note 16(a)) and assessment of the outstanding risk and obligations in recognition of profit from property development (see note 30).

### *(b) Critical accounting judgements in applying the KCRC Group's accounting policies*

Critical accounting judgements in applying the KCRC Group's accounting policies include the classification of revenue and expenditure as capital or revenue in nature (see note 2(i)(i)), the classification of revenue and cost-recovery, the classification of operating leases or lease-out and lease-back transactions, transfers from construction in progress to fixed assets (see note 2(m)), assessment of controlled and non-controlled subsidiaries (see note 2(d)), the categorisation of financial assets and liabilities, adoption of hedge accounting (see note 33) and impairment of assets (see note 40).

## 43 Possible impact of amendments, new standards and interpretations issued but not yet effective for the annual accounting year ended 30 June 2007

Up to the date of issue of these financial statements, the HKICPA has issued a number of amendments, new standards and interpretations which are not yet effective for the year ended 31 December 2006 and which have not been adopted in these financial statements.

The KCRC Group is in the process of making an assessment of what the impact of these amendments, new standards and new interpretations is expected to be in the period of initial application. So far it has concluded that the adoption of them is unlikely to have a significant impact on the Group's and the Corporation's results of operations and financial position.

In addition, the following developments may result in new or amended disclosures in the financial statements:

| | **Effective for accounting periods beginning on or after** |
|---|---|
| HK(IFRIC) Int 12, Service Concession arrangements | 1 January 2008 |
| HKFRS 8, Operating segments | 1 January 2009 |

## 44 Additional financial information of KCRC

Under the proposed Rail Merger, certain agreements are to be entered into with regard to the KCRC business and operations (collectively referred to as "Transaction Documents") as set out below. The terms of the proposed Rail Merger as prescribed in the Transaction Documents, are such that MTRC will acquire substantially all the business operations of KCRC and the residual operations of KCRC post merger would predominantly be of an administrative nature only.

The Transaction Documents include:

- Service Concession Agreement ("SCA") in respect of the grant to MTRC of the rights to access, use and operate the Hong Kong section of the Kowloon-Canton Railway ("railway network") for a specified term.

- Property Package Agreements whereby property assets comprising certain investment and own-use properties, property management rights and property development rights (collectively referred to as the "Property Package") currently held by the KCRC are to be acquired by MTRC.

- Merger Framework Agreement in respect of the proposed framework for the Rail Merger.

Under the terms of the SCA, the tangible assets that form part of the railway network are subject to a service concession arrangement whereby MTRC will have the right to access, use and operate these assets. These tangible assets comprise of tangible assets that exist on the date of the proposed Rail Merger ("Initial Concession Property") and those assets that are subsequently acquired after the date of the proposed Rail Merger ("Additional Concession Property"). Ownership of the Initial Concession Property will remain with KCRC. As the Initial Concession Property assets will not be acquired by MTRC under the terms of the Transaction Documents, they will continue to form part of KCRC's fixed assets. Under HK(IFRIC) 12 "*Service Concession Arrangements*", MTRC would not recognise such railway assets on its balance sheet and would recognise a service concession asset in respect of payments to acquire the right to operate the railway assets of KCRC. Accordingly, the railway assets of KCRC would remain recognised in KCRC's financial statements as fixed assets.

Under the Transaction Documents, certain specified assets and liabilities are not included in the proposed arrangements. The railway construction in progress relating to the East Rail Extension and the Kowloon Southern Link which will continue to be funded by KCRC, the deferred expenditure relating to the Shatin-Central Link and the Northern Link / Express Rail, the debt and cross-border leases of KCRC, cash balances of KCRC (apart from cash balances in subsidiaries to be acquired) prior to the merger date, the investment in Octopus Holdings Limited, the West Rail property subsidiaries and certain property arrangements are excluded from the terms of the Transaction Documents. In addition, deferred taxation is not included in the Transaction Documents and does not form part of the arrangements.

To facilitate the understanding of the proposed arrangements, the application of the terms of the Transaction Documents and those items that would be accounted for differently in MTRC's books after the merger and how such financial information would be set out in the unaudited proforma information set out in Appendix VII to the Circular, the following additional financial information is included for reference.

***(a) For the year ended 31 December 2006***

| | Consolidated profit and loss account of KCRC for the year ended 31 December 2006 | Reclassifications | Adjustments for items excluded per the Transaction Documents | | Adjusted Consolidated profit and loss account of KCRC for the year ended 31 December 2006 |
|---|---|---|---|---|---|
| | *HK$ million* | *HK$ million* *Note 1* | *HK$ million* | *Note* | *HK$ million* |
| **Turnover** | 5,622 | | (18) | *2* | 5,604 |
| **Operating expenses before depreciation and amortisation** | (3,042) | (39) | 50 | *3* | (3,031) |
| **Operating profit from railway and related operations before depreciation and amortisation** | 2,580 | | | | 2,573 |
| Profit on property development | — | 427 | (427) | *4* | — |
| **Operating profit before depreciation and amortisation** | 2,580 | | | | 2,573 |
| Depreciation and amortisation | (2,288) | | 2,277 | *5* | (11) |
| **Operating profit before interest and finance charges** | 292 | | | | 2,562 |
| Net interest and finance charges | (316) | (159) | 475 | *6* | — |
| Change in fair value of investment properties | — | 99 | (99) | *7* | — |
| Profit on property development | 427 | (427) | | | — |
| Share of profit less losses of non-controlled subsidiaries and associates | 27 | | (27) | *8* | — |
| **Profit before unrealised gains/losses** | 430 | | | | 2,562 |
| Loss on changes in fair value of derivative financial instruments and hedged borrowings | (198) | 198 | | | — |
| Net value gains on investment properties | 99 | (99) | | | — |
| **Profit before tax** | 331 | | | | 2,562 |
| Income tax | (53) | | (395) | *9* | (448) |
| **Profit for the year** | 278 | | | | 2,114 |

*Notes:*

1 Represents reclassification of certain account balances to align with presentation adopted by MTRC.

2 The amount represents net revenue of HK$18 million in relation to the lease out and lease back arrangement for railway related assets which are excluded under the terms of the Transaction Documents.

3 The amount represents expenditure of HK$50 million for the remedial works arising from the crack incident of East Rail which are excluded under the terms of the Transaction Documents.

4 Property development profit of HK$427 million earned prior to the Merger Date and not included in the Transaction Documents.

5 Depreciation charge of HK$2,277 million on railway assets that are subject to a service concession arrangement and are not being acquired by MTRC under the SCA and which will remain recognised in KCRC's statutory financial statements as fixed assets.

6 Interest and finance charges on KCRC's debt obligations not acquired by MTRC.

7 Adjustment to exclude changes in the fair value of investment properties recognised by KCRC on the investment properties acquired by MTRC based on an agreed consideration.

8 Share of profit on associate (Octopus Holdings Limited) of HK$27 million excluded in the Transaction Documents.

9 Adjustment to exclude tax relating to certain excluded items.

*(b) For the six months ended 30 June 2007*

| | Consolidated profit and loss account of KCRC for the six month ended 30 June 2007 | Reclassifications | Adjustments for items excluded per the Transaction Documents | | Adjusted Consolidated profit and loss account of KCRC for the six month ended 30 June 2007 |
|---|---|---|---|---|---|
| | *HK$ million* | *HK$ million* *Note 1* | *HK$ million* | *Note* | *HK$ million* |
| **Turnover** | 2,838 | | (9) | *2* | 2,829 |
| **Operating expenses before depreciation and amortisation** | (1,531) | (13) | 4 | *3* | (1,540) |
| **Operating profit from railway and related operations before depreciation and amortisation** | 1,307 | | | | 1,289 |
| Profit on property development | — | | | | — |
| **Operating profit before depreciation and amortisation** | 1,307 | | | | 1,289 |
| Depreciation and amortisation | (1,153) | | 1,146 | *4* | (7) |
| **Operating profit before interest and finance charges** | 154 | | | | 1,282 |
| Net interest and finance charges | (432) | 296 | 136 | *5* | — |
| Change in fair value of investment properties | — | 6 | (6) | *6* | — |
| Profit on property development | — | | | | — |
| Share of profit less losses of non-controlled subsidiaries and associates | 16 | | (16) | *7* | — |
| **(Loss)/profit before unrealised gains/losses** | (262) | | | | 1,282 |
| Gain on changes in fair value of derivative financial instruments and hedged borrowings | 283 | (283) | | | — |
| Net value gains on investment properties | 6 | (6) | | | — |
| **Profit before tax** | 27 | | | | 1,282 |
| Income tax | (8) | | (217) | *8* | (225) |
| **Profit for the period** | 19 | | | | 1,057 |

*Notes:*

1 Represents reclassification of certain account balances to align with presentation adopted by MTRC.

2 The amount represents net revenue of HK$9 million in relation to the lease out and lease back arrangement for railway related assets which are excluded under the terms of the Transaction Documents.

3 The amount represents expenditure of HK$4 million for the remedial works arising from the crack incident of East Rail which are excluded under the terms of the Transaction Documents.

4 Depreciation charge of HK$1,146 million on railway assets that are subject to a service concession arrangement and are not being acquired by MTRC under the SCA and which will remain recognised in KCRC's statutory financial statements as fixed assets.

5 Interest and finance charges on KCRC's debt obligations not acquired by MTRC.

6 Adjustment to exclude changes in fair value of investment properties recognised by KCRC on the investment properties acquired by MTRC based on an agreed consideration.

7 Share of profit on associate (Octopus Holdings Limited) of HK$16 million excluded in the Transaction Documents.

8 Adjustment to exclude tax relating to certain excluded items.

*(c) For the year ended 31 December 2006*

| | Consolidated Cash Flow Statement of KCRC for the year ended 31 December 2006 | Reclassifications | Adjustments for items excluded per the Transaction Documents | Note | Adjusted Consolidated Cash Flow Statement of KCRC for the year ended 31 December 2006 |
|---|---|---|---|---|---|
| | *HK$ million* | *HK$ million* *Note 1* | *HK$ million* | *Note* | *HK$ million* |
| **Cash flows from operating activities** | | | | | |
| Operating profit from railway and related businesses before depreciation | 2,580 | (39) | 32 | *2* | 2,573 |
| Adjustments for non-cash items | 24 | 39 | | | 63 |
| Operating profit from railway and related businesses before working capital changes | 2,604 | | | | 2,636 |
| Changes in working capital | 60 | | 24 | *2* | 84 |
| Cash generated from operations | 2,664 | | | | 2,720 |
| Net cash outflow from property development | 1,505 | (1,505) | | | — |
| Profits tax paid | (1) | | | | (1) |
| *Net cash inflow from operating activities* | 4,168 | | | | 2,719 |
| **Cash flows from investing activities** | | | | | |
| Capital expenditure | (4,522) | (42) | 4,175 | *3* | (389) |
| Receipts in respect of property development | — | 1,547 | (1,547) | *4* | — |
| Loan to a property developer | — | | | | — |
| Receipts on sales of fixed assets | 5 | | | | 5 |
| Other investments | 1,770 | (237) | (1,533) | *5* | — |
| *Net cash outflow from investing activities* | (2,747) | | | | (384) |
| **Cash flows from financing activities** | | | | | |
| Proceeds from shares issued | — | | | | — |
| Net drawdown of loans and capital market instruments | (298) | | 298 | *6* | — |
| Reduction in capital element of finance lease | — | | | | — |
| Net interest and finance charges paid | (1,486) | 237 | 1,249 | *7* | — |
| Dividends paid | — | | | | — |
| *Net cash outflow from financing activities* | (1,784) | | | | — |
| Net (decrease)/increase in cash and cash equivalents | (363) | | | | 2,335 |
| Cash and cash equivalents at 1 January | 1,839 | | (1,728) | *8* | 111 |
| Cash and cash equivalents at 31 December | 1,476 | | | | 2,446 |

*Notes:*

1 Represents reclassification of certain account balances to align with presentation adopted by MTRC.

2 Net expenditure of HK$6 million in relation to the lease out and lease back arrangement for railway related assets and expenditures of HK$50 million arising from the crack incident of East Rail are not acquired by MTRC under the terms of the Transaction Documents.

3 Capital expenditure of HK$4,175 million relating to East Rail Extensions, Kowloon-Southern Link, West Rail, Northern Link / Express Rail Link, Shatin to Central Link and the crack incident which is to remain the funding obligation of KCRC under terms of the Transaction Documents.

4 Adjustment to exclude receipts in respect of certain property developments of HK$1,547 million prior to Merger Date.

5 Adjustment for HK$1,533 million represents:

| | *Notes* | *HK$ million* |
|---|---|---|
| Repayment of loan from non-controlled subsidiary | i | 38 |
| Movement in deposits with banks with over three months maturity | ii | 1,084 |
| Receipts on redemption and disposal of securities | iii | 411 |
| | | 1,533 |

(i) Repayment of loan from non-controlled subsidiary which is excluded from the terms of the Transaction Documents.

(ii) Movements in deposits with banks with maturity more than three months when placed which are excluded under the terms of the Transaction Documents.

(iii) Receipts on redemption and disposal of available-for-sale securities are excluded under the terms of the Transaction Documents

6 Repayment of loan obligation of HK$298 million which is excluded from the terms of the Transaction Documents.

7 Net interest and finance charges paid by KCRC in respect of debt obligations not acquired by MTRC under the terms of the Transaction Documents.

8 Cash balances of KCRC before Merger Date are excluded from the terms of the Transaction Documents (apart from cash in acquired subsidiaries).

*(d) For the six months ended 30 June 2007*

| | **Consolidated Cash Flow Statement of KCRC for the six month ended 30 June 2007** | **Reclassifications** | **Adjustments for items excluded per the Transaction Documents** | | **Adjusted Consolidated Cash Flow Statement of KCRC for the six month ended 30 June 2007** |
|---|---|---|---|---|---|
| | *HK$ million* | *HK$ million Note 1* | *HK$ million* | *Note* | *HK$ million* |
| **Cash flows from operating activities** | | | | | |
| Operating profit from railway and related businesses before depreciation | 1,307 | (13) | (5) | *2* | 1,289 |
| Adjustments for non-cash items | 19 | 13 | | | 32 |
| Operating profit from railway and related businesses before working capital changes | 1,326 | | | | 1,321 |
| Changes in working capital | 169 | | 12 | *2* | 181 |
| Cash generated from operations | 1,495 | | | | 1,502 |
| Net cash outflow from property development | (26) | 26 | | | — |
| Profits tax paid | (1) | | | | (1) |
| *Net cash inflow from operating activities* | 1,468 | | | | 1,501 |
| **Cash flows from investing activities** | | | | | |
| Capital expenditure | (1,662) | (26) | 1,518 | *3* | (170) |
| Receipts in respect of property development | — | | | | — |
| Loan to a property developer | — | | | | — |
| Receipts on sales of fixed assets | — | | | | — |
| Other investments | 276 | (30) | (246) | *4* | — |
| *Net cash outflow from investing activities* | (1,386) | | | | (170) |
| **Cash flows from financing activities** | | | | | |
| Proceeds from shares issued | — | | | | — |
| Net drawdown of loans and capital market instruments | (392) | | 392 | *5* | — |
| Reduction in capital element of finance lease | — | | | | — |
| Net interest and finance charges paid | (751) | 30 | 721 | 6 | — |
| Dividends paid | (82) | | 82 | *7* | — |
| *Net cash outflow from financing activities* | (1,225) | | | | — |
| Net (decrease)/increase in cash and cash equivalents | (1,143) | | | | 1,331 |
| Cash and cash equivalents at 1 January | 1,476 | | | | 2,446 |
| Cash and cash equivalents at 30 June | 333 | | | | 3,777 |

*Notes:*

1 Represents reclassification of certain account balances to align with presentation adopted by MTRC.

2 Net expenditure of HK$3 million in relation to the lease out and lease back arrangement for railway related assets and expenditures of HK$4 million arising from the crack incident of East Rail are not acquired by MTRC under the terms of the Transaction Documents.

3 Capital expenditure of HK$1,518 million relating to East Rail Extensions, Kowloon-Southern Link, West Rail, Northern Link / Express Rail Link, Shatin to Central Link and the crack incident which is to remain the funding obligation of KCRC under terms of the Transaction Documents.

4 Adjustment for HK$246 million represents:

| | *Notes* | *HK$ million* |
|---|---|---|
| Repayment of loan from non-controlled subsidiary | i | (13) |
| Movement in deposits with banks with over three months maturity | ii | 259 |
| | | 246 |

i Repayment of loan from non-controlled subsidiary which is excluded from the terms of the Transaction Documents.

ii Movements in deposits with banks with maturity more than three months when placed which are excluded under the terms of the Transaction Documents.

5 Repayment of loan obligation of HK$392 million which is excluded from the terms of the Transaction Documents.

6 Net interest and finance charges paid by KCRC in respect of debt obligations not acquired by MTRC under the terms of the Transaction Documents.

7 The amount represents dividend paid by KCRC for the year not included in the Transaction Documents.

*(e) As at 30 June 2007*

| | Consolidated Balance Sheet of KCRC as at 30 June 2007 | Reclassifications | Adjustments for items excluded per the Transaction Documents | Note | Adjusted Consolidated Balance Sheet of KCRC as at 30 June 2007 |
|---|---|---|---|---|---|
| | *HK$ million* | *HK$ million* | *HK$ million* | *Note* | *HK$ million* |
| | | *Note 1* | | | |
| **Assets** | | | | | |
| Fixed assets | | | | | |
| - Investment properties | 1,384 | 160 | | | 1,544 |
| - Other property, plant and equipment | 57,658 | 5,621 | (63,245) | *2* | 34 |
| | 59,042 | | | | 1,578 |
| Interest in leasehold land held for own use under operating lease | 5,471 | (5,471) | | | — |
| Property management rights | — | | | | — |
| Construction in progress | 15,145 | (15,145) | | | — |
| Railway construction in progress | — | 14,835 | (14,835) | *3* | — |
| Property development in progress | 457 | | (457) | *4* | — |
| Loan to a property developer | — | | | | — |
| Debtors, deposits and payments in advance | 463 | (320) | (141) | *5* | 2 |
| Stores and spares | 367 | | (12) | *6* | 355 |
| Other assets | 5,889 | 322 | (6,209) | *5* | 2 |
| Cash and cash equivalents | 545 | | (395) | *7* | 150 |
| | 87,379 | | | | 2,087 |
| **Liabilities** | | | | | |
| Loans and other financing | 18,852 | | (18,852) | *8* | — |
| Deferred income | 562 | (60) | (469) | *9* | 33 |
| Deferred tax liabilities | 3,257 | 2 | (3,259) | *10* | — |
| Other liabilities | 4,838 | 60 | (4,010) | *11* | 888 |
| | 27,509 | | | | 921 |
| **Net assets** | 59,870 | | | | 1,166 |

*Notes:*

1. Represents reclassification of certain account balances to align with balance sheet presentation adopted by MTRC primarily in respect of interest in leasehold land and railway construction in progress.

2. Railway assets of HK$63,245 million recognised in KCRC's statutory financial statements as fixed assets and not acquired by MTRC, which are subject to the service concession arrangement.

3. Railway construction in progress of HK$14,835 million relating to the East Rail Extension and Kowloon Southern Link which remain the funding responsibility of KCRC.

4 Property development in progress of HK$457 million in respect of property enabling works and other property related expenditure which remain the funding responsibility of KCRC.

5 Other assets mainly representing the loan to non-controlled subsidiaries of West Rail property developments of HK$4,214 million, deferred expenditure of HK$1,490 million on Shatin to Central Link and Northern Link/ Express Rail Link, interest in associate of HK$115 million, derivative financial assets of HK$70 million, interest and other receivables of HK$141 million and amounts due from Government of HK$320 million not acquired by MTRC under the terms of the Transaction Documents.

6 Represents stores and spares excluded under the terms of the Transaction Documents.

7 Cash of KCRC is excluded under the terms of the Transaction Documents (apart from cash in acquired subsidiaries).

8 Loans and other financing of HK$18,852 million of KCRC not acquired by MTRC under the terms of the Transaction Documents.

9 Deferred income in respect of asset leasing and amount brought forward before the Merger Date, in respect of property development, not subject to the terms of the agreements.

10 Deferred tax liabilities of HK$3,259 million which remain in KCRC and are not acquired by MTRC.

11 Other liabilities mainly representing accrued charges for capital projects relating to East Rail Extension, West Rail and Kowloon-Southern Link not acquired by MTRC under the terms of the Transaction Documents

## C. SUBSEQUENT FINANCIAL STATEMENTS

No audited financial statements have been prepared by KCRC Group in respect of any period subsequent to 30 June 2007.

Yours faithfully
**KPMG**
*Certified Public Accountants*
Hong Kong

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR KCRC

The following discussion should be read in conjunction with the KCRC's audited consolidated financial statements for the years ended 31 December 2004, 2005 and 2006, and the six months end 30 June 2007, as well as unaudited financial statements for the six months ended 30 June 2006, together with the notes thereto included elsewhere in this Circular.

### Overview

KCRC operate a commuter railway system linking the suburban areas of Hong Kong with the urban areas. Its main lines are the 46.5-km East Rail line (which includes the Tsim Sha Tsui Extension and the Ma On Shan Rail) and the 30.5-km West Rail line.

The East Rail line comprises a total of 14 stations from East Tsim Sha Tsui Station, the main terminus in urban Kowloon, to Lo Wu, the terminus on the boundary with mainland China, and a further 8 stations on the Ma On Shan Rail from Tai Wai to Wu Kai Sha. This line carried, on average, approximately 918,000 passenger-trips a day in 2006. It is a mass transit carrier with a peak hour frequency of 2.5 and 3 minutes for the East Rail main line and the Ma On Shan Rail, respectively. KCRC also operates intercity passenger services to Guangzhou on its own trains and provide access for other intercity passenger trains running to and from six cities in mainland China, namely Dongguan, Guangzhou, Foshan, Zhaoqing, Beijing and Shanghai. The West Rail line comprises a total of nine stations from Tuen Mun to Nam Cheong. The West Rail operates up to 18 seven-car trains per hour, with a peak hour frequency of 3.5 minutes. This line carried on average 200,100 passenger-trips a day in 2006. The Light Rail system serves the northwestern New Territories, by linking up the townships of Tuen Mun, Yuen Long and Tin Shui Wai. The system principally comprises tram-like vehicles that carried, on average, approximately 373,800 passenger-trips a day in 2006. KCRC also carries cargo, primarily textiles, foodstuffs, metals, chemicals and livestock on the East Rail, and have feeder buses in the Light Rail network as well as connecting the East Rail and the West Rail stations to the neighbouring areas.

In 2006, KCRC's railway network (including buses) carried a total of 577.3 million passengers, or an average of 1.58 million passengers per day, an increase of 3.8% from 2005.

KCRC supplements its railway revenues with revenues from property development, ownership and management of investment properties, property management services and other commercial activities ancillary to its railway business, such as shop leasing, advertising and telecommunications.

KCRC's remuneration policies are to be competitive in the market in order to attract and retain talent and to pay by performance through a standard stretching variable pay scheme to incentivise excellent performance.

KCRC places emphasis on providing comprehensive, tailor-made development programmes that not only enhances specific and leadership skills of individuals but also on the wellness of its staff in general. KCRC has a training policy of providing each employees of an average of seven days' training a year.

Since KCRC is wholly-owned by the Government, its motivation in operating its services differs from private corporations, which would seek to maximise corporate profits. Nevertheless, under the Kowloon-Canton Railway Corporation Ordinance, KCRC is required to operate on prudent commercial principles. Its financial strategy is to generate sufficient revenues from customers to cover operating costs, maintain and improve the quality of plant, equipment and service, repay its debt and earn a reasonable rate of return for the Government.

**Results of Operations**

| | For the years ended 31 December | | | For the six months ended 30 June | |
|---|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2007 | 2006 |
| | *$ million* | *$ million* | *$ million* | *$ million* | *$ million (unaudited)* |
| **Turnover** | | | | | |
| Transport services | | | | | |
| Passenger services | | | | | |
| - East Rail | 3,780 | 3,670 | 3,415 | 1,883 | 1,841 |
| - West Rail and Light Rail | 922 | 890 | 798 | 463 | 448 |
| Freight services | 44 | 52 | 68 | 21 | 21 |
| | 4,746 | 4,612 | 4,281 | 2,367 | 2,310 |
| Property services | 876 | 771 | 695 | 471 | 426 |
| | 5,622 | 5,383 | 4,976 | 2,838 | 2,736 |
| Operating costs before depreciation and amortisation | (3,042) | (3,027) | (2,804) | (1,531) | (1,474) |
| **Operating profit before depreciation and amortisation** | 2,580 | 2,356 | 2,172 | 1,307 | 1,262 |
| Depreciation and amortisation | (2,288) | (2,258) | (1,681) | (1,153) | (1,137) |
| **Operating profit after depreciation and amortisation** | 292 | 98 | 491 | 154 | 125 |
| Interest and finance income | 499 | 525 | 444 | 213 | 257 |
| Interest and finance expenses | (815) | (823) | (485) | (645) | (404) |
| Profit from property development | 427 | — | — | — | — |
| Share of profit of associate | 27 | 15 | 15 | 16 | 11 |
| **Profit/(loss) before unrealised gains/losses** | 430 | (185) | 465 | (262) | (11) |
| Gains/(losses) on changes in fair value of derivative financial instruments and hedged borrowings | (198) | 400 | — | 283 | (112) |
| Net valuation gains on investment properties | 99 | 171 | 148 | 6 | 43 |
| **Profit/(loss) before taxation** | 331 | 386 | 613 | 27 | (80) |
| Income tax | (53) | (69) | (100) | (8) | 20 |
| **Profit/(loss) for the year/period wholly attributable to the sole shareholder of the Corporation** | 278 | 317 | 513 | 19 | (60) |
| Dividend payable to the sole shareholder of the Corporation attributable to the year/period proposed after the balance sheet date | 82 | — | 172 | — | — |

**Other Information**

| | For the years ended 31 December | | | For the six months ended 30 June | |
|---|---|---|---|---|---|
| | 2006 | 2005 | 2004 | 2007 | 2006 |
| **Financial data** | | | | | |
| Debt/equity ratio | 1:3.1 | 1:3.1 | 1:3.0 | 1:3.4 | 1:3.1 |
| Interest cover (times) | 2.2 | 1.9 | 1.8 | 1.8 | 2.0 |
| **Employees at year end (number)** | | | | | |
| Transport | 4,524 | 4,372 | 4,227 | 4,480 | 4,531 |
| Property | 131 | 111 | 109 | 126 | 126 |
| Capital Projects | 733 | 754 | 867 | 716 | 757 |
| Corporate & other services | 661 | 642 | 671 | 655 | 645 |
| | 6,049 | 5,879 | 5,874 | 5,977 | 6,059 |

**Comparison of the six months ended 30 June 2007 to the six months ended 30 June 2006**

Total revenue from operations was $2,838 million for the six months ended 30 June 2007, a 3.7% increase from $2,736 million for the six months ended 30 June 2006. This increase included a 2.5% increase in revenue from railway and bus operations (excluding freight) to $2,346 million and a 10.6% increase in property services revenue to $471 million, whereas the revenue for freight remains the same as that for the six months ended 30 June 2006. Revenue from the East Rail increased by 2.3% from $1,841 million for the six months ended 30 June 2006 to $1,883 million for the six months ended 30 June 2007. This increase in the East Rail's revenue was mainly due to the growth of the cross-boundary market and the fact that the further improvement of economy encouraged more domestic ridership. Revenues from the West Rail and the Light Rail increased by 3.3% to $463 million for the six months ended 30 June 2007 from $448 million for the six months ended 30 June 2006, mainly because of the increase in the West Rail patronage resulting from the continuation of various measures to improve accessibility and the introduction of promotional offers. Recurrent revenue from property activities increased by 10.6% to $471 million for the six months ended 30 June 2007 from $426 million for the six months ended 30 June 2006, mainly because of the improved performance of duty free business, shopping centres, advertising and station trading.

Operating profit after depreciation and amortisation increased by 23.2% to $154 million for the six months ended 30 June 2007, compared with $125 million for the six months ended 30 June 2006, mainly because of the growth in revenue income. Operating margin before depreciation and amortisation and net interest and finance income/(expenses) (before tax) remains at 46.1% for the six months ended 30 June 2007, the same as that for the six months ended 30 June 2006. Operating costs before depreciation and amortisation for the six months ended 30 June 2007 increased by 3.9% to $1,531 million from $1,474 million for the six months ended 30 June 2006. Staff costs increased by 2.6% to $789 million for the six months ended 30 June 2007 from $769 million for the six months ended 30 June 2006, energy costs increased by 5.4% to $236 million for the six months ended 30 June 2007 from $224 million for the six months ended 30 June 2006, and maintenance costs decreased by 5.9% to $238 million for the six months ended 30 June 2007 from $253 million for the six months ended 30 June 2006. In addition, other expenses increased by 17.5% to $268 million for the six months ended 30 June 2007 from $228 million for the six months ended 30 June 2006.

Net interest and finance expenses increased from $147 million for the six months ended 30 June 2006 to $432 million for the six months ended 30 June 2007, mainly due to the fact that the interest expenses in relation to Lok Ma Chau ("LMC") Spur Line were no longer capitalised from April 2007 onwards. The net unrealised accounting profit resulting from the changes in fair value of investment properties, financial instruments and the hedged portion of the interest-bearing borrowings were $289 million for the six months ended 30 June 2007, compared with a loss of $69 million for the six months ended 30 June 2006. A share of profit from an associate of $16 million was recognised for the six months ended 30 June 2007, compared with $11 million for the six months ended 30 June 2006, representing an increase of 45.5%. Net income tax charge of $8 million was recognised for the six months ended 30 June 2007, compared with a net income tax credit of $20 million for the six months ended 30 June 2006.

**Comparison of the year ended 31 December 2006 to the year ended 31 December 2005**

Total revenue from operations was $5,622 million for 2006, a 4.4% increase from $5,383 million for 2005. This increase included a 3.1% increase in revenue from railway and bus operations (excluding freight) to $4,702 million, a 15.4% decrease in freight revenue to $44 million, and a 13.6% increase in property services revenue to $876 million for 2006 compared with that for 2005. Revenue from the East Rail increased by 3.0% from $3,670 million for 2005 to $3,780 million for 2006. This increase in the East Rail's revenue was mainly due to the growth of the cross-boundary market and the continuous build up in patronage on the Tsim Sha Tsui Extension and the Ma On Shan Rail. Revenues from the West Rail and the Light Rail increased 3.6% to $922 million from $890 million in 2005, mainly because of the increase in the West Rail patronage resulting from the continuation of various measures to improve accessibility and the introduction of promotional offers. Recurrent revenue from property activities increased to $876 million, up 13.6% from $771 million in 2005, mainly because of the improved performance of duty free business, shopping centers, advertising, exhibition and station trading. Revenue from freight services decreased by 15.4% to $44 million in 2006 from $52 million in 2005, mainly due to decreases in rail freight traffic and the cessation of our freight forwarding business in December 2005.

Operating profit after depreciation and amortisation increased by 198% to $292 million in 2006, compared with $98 million in 2005, mainly because of the growth in revenue income. Operating margin before depreciation and amortisation and net interest and finance income/(expenses) (before tax) increased from 43.8% in 2005 to 45.9% in 2006. Operating costs before depreciation and amortisation for 2006 increased by 0.5% to $3,042 million from $3,027 million in 2005. Staff costs increased by 1.4% to $1,543 million from $1,521 million in 2005, energy costs decreased by 2.2% to $484 million from $495 million in 2005, and maintenance costs increased by 9.0% to $522 million from $479 million in 2005. In addition, other expenses decreased by 7.3% to $493 million from $532 million in 2005.

Net interest and finance expenses increased from $298 million in 2005 to $316 million in 2006 primarily due to the reduction in interest and finance income. The net unrealised accounting losses resulting from the changes in fair value of investment properties, financial instruments and the hedged portion of the interest-bearing borrowings were $99 million in 2006, compared with a profit of $571 million in 2005. Profit from property development of $427 million was recognised in 2006. A share of profit from an associate of $27 million was recognised in 2006, compared with $15 million in 2005, representing an increase of 80.0%. Net income tax charge of $53 million was recognised in 2006, compared with $69 million in 2005.

**Comparison of the year ended 31 December 2005 to the year ended 31 December 2004**

Total revenue from operations was $5,383 million for 2005, an 8.2% increase from $4,976 million for 2004. This increase included an 8.2% increase in revenue from railway and bus operations (excluding freight) to $4,560 million, a 23.5% decrease in freight revenue to $52 million, and a 10.9% increase in property services revenue to $771 million for 2005 compared with that for 2004. Revenue from the East Rail increased by 7.5% from $3,415 million for 2004 to $3,670 million for 2005. This increase in the East Rail's revenue was mainly due to increased patronage resulting from the full year operation of the Tsim Sha Tsui Extension and the Ma On Shan Rail. Revenues from the West Rail and the Light Rail increased 11.5% to $890 million from $798 million in 2004, mainly because of the significant increase in patronage resulting from the continuation of various measures to improve accessibility and the introduction of promotional offers. Recurrent revenue from property activities increased by 10.9% to $771 million from $695 million in 2004, mainly because of the full year opening of new station shops at East Tsim Sha Tsui Station and along the Ma On Shan Rail. Revenue from freight services decreased by 23.5% to $52 million in 2005 from $68 million in 2004, mainly due to decreases in rail freight traffic and the winding down of our freight forwarding business.

Operating profit after depreciation and amortisation declined by 80% to $98 million in 2005, compared with $491 million in 2004, mainly because of the increase in operating cost and depreciation and amortisation resulting from the full year operation of the Tsim Sha Tsui Extension and the Ma On Shan Rail. Operating margin before depreciation and amortisation and net interest and finance income/(expenses) (before tax) increased from 43.6% in 2004 to 43.8% in 2005. Operating costs before depreciation and amortisation for 2005 increased by 8.0% to $3,027 million from $2,804 million in 2004. Staff costs increased by 4.0% to $1,521 million from $1,462 million in 2004, energy costs increased by 8.6% to $495 million from $456 million, and maintenance costs increased by 29.5% to $479 million from $370 million in 2004. In addition, other expenses increased by 3.1% to $532 million from $516 million in 2004.

Net interest and finance expenses increased from $41 million in 2004 to $298 million in 2005 mainly because of the full year interest expenses related to the Tsim Sha Tsui Extension and the Ma On Shan Rail upon their commissioning in late 2004. With the reassessment of our accounting treatment of derivative financial instruments for prior years, the change in fair value of such derivative financial instruments and the related hedged borrowings has to be recognised directly in the income statement. The effect of change is applied prospectively from 1 January 2005. As a result, a gain resulting from the change in fair value of derivative financial instruments and the related hedged borrowings amounting to $400 million has been recognised in 2005. No property development profit was realised in 2004 and 2005. A share of profit from an associate of $15 million was recognised in 2005, which is the same as that recognised in 2004. Net income tax charge in the amount of $69 million was recognised in 2005, compared with $100 million in 2004.

**Contingent Liabilities**

At 30 June 2007, the KCRC Group had contingent liabilities arising from the land resumption claims and certain contractors' claims in respect of the construction of the Kowloon Southern Link, West Rail and East Rail Extensions projects where the KCRC Group's total obligations cannot be estimated reliably. The KCRC Group has made provision in the financial statements at 30 June 2007 for its best estimate of amounts which are likely to be payable in connection with these claims. The amounts payable upon resolution of the claims may be eventually in excess of amounts estimated by the KCRC Group and accounted for in the financial statements at 30 June 2007. The KCRC Group is in the process of resolving these claims.

*For illustrative purposes only, set out below is the unaudited pro forma financial information of MTR Corporation Limited (the "Company") and its subsidiaries (hereinafter collectively referred to as the "Group") after completion of the proposed merger with the relevant operations of Kowloon-Canton Railway Corporation ("KCRC") (collectively referred to as the "Enlarged Group") and after taking into account the terms of the Transaction Documents.*

## (A) UNAUDITED PRO FORMA FINANCIAL INFORMATION OF THE ENLARGED GROUP

### (I) Introduction

The accompanying unaudited Pro Forma Financial Information of the Enlarged Group comprising the unaudited pro forma combined profit and loss account, unaudited pro forma combined cash flow statement and unaudited pro forma combined balance sheet of the Enlarged Group, has been prepared by the directors of the Company in accordance with paragraph 4.29 of The Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, to illustrate the effect of the Transaction Documents with regard to the proposed Rail Merger.

The unaudited Pro Forma Financial Information of the Enlarged Group should be read in conjunction with the financial information of the Group contained in the Appendix IV to this Circular headed "Financial Information of the Group", the financial information of the KCRC Group contained in the Appendix V to this Circular headed "Accountants' Report on KCRC" and other financial information included elsewhere in this Circular.

The unaudited pro forma combined profit and loss account and the unaudited pro forma combined cash flow statement of the Enlarged Group have been prepared based on the consolidated profit and loss account and the consolidated cash flow statements of the Group and KCRC Group for the year ended 31 December 2006 and six months ended 30 June 2007 as contained in Appendix IV to this Circular headed "Financial Information of the Group" and in the Appendix V to this Circular headed "Accountants' Report on KCRC", after incorporating the unaudited pro forma adjustments described in the accompanying notes, as if the proposed Rail Merger had been completed on 1 January 2006.

The unaudited pro forma combined balance sheet of the Enlarged Group is prepared based on the consolidated balance sheet of the Group as at 30 June 2007, as contained in the Appendix IV to this Circular headed "Financial Information of the Group", and the consolidated balance sheet of the KCRC Group as at 30 June 2007 as contained in the Appendix V to this Circular headed "Accountants' Report on KCRC", and which has been adjusted where necessary for those assets and liabilities which are not subject to the terms of the Transaction Documents, as if the proposed Rail Merger had been completed on 30 June 2007.

A narrative description of the pro forma adjustments that are (i) directly attributable to the transactions concerned and not relating to future events or decisions; (ii) expected to have a continuing impact on the Enlarged Group; and (iii) factually supportable, are summarised in the accompanying notes.

The unaudited Pro Forma Financial Information of the Enlarged Group is based on a number of assumptions, estimates, uncertainties and currently available information. As a result of these assumptions, estimates and uncertainties, the accompanying unaudited Pro Forma Financial Information of the Enlarged Group does not purport to describe the actual financial position of the Enlarged Group that would have been attained had the proposed Rail Merger been completed on 30 June 2007, or the results and cash flows of the Enlarged Group that would have been attained had the proposed Rail Merger been completed on 1 January 2006. It is prepared for illustrative purposes only and the accompanying unaudited Pro Forma Financial Information of the Enlarged Group does not purport to predict the Enlarged Group's future financial position, results or cash flows.

## (II) Unaudited pro forma combined profit and loss account of the Enlarged Group For the year ended 31 December 2006

| | Consolidated Profit and Loss Account of MTRC | Adjusted Consolidated Profit and Loss Account of KCRC | Unaudited Pro forma Adjustments | | Total Adjustments | Combined Profit and Loss Account of Enlarged Group Pro forma Total |
|---|---|---|---|---|---|---|
| | *HK$ million* | *HK$ million* | *HK$ million* | | *HK$ million* | *HK$ million* |
| | *Note 1* | *Note 2* | | *Note 3* | | |
| Fare revenue | 6,523 | 4,598 | — | | 4,598 | 11,121 |
| Non-fare and rental and management income | 3,018 | 1,006 | — | | 1,006 | 4,024 |
| **Turnover** | 9,541 | 5,604 | — | | 5,604 | 15,145 |
| **Operating expenses before depreciation and amortisation** | (4,340) | (3,031) | — | | (3,031) | (7,371) |
| **Operating profit from railway and related operations before depreciation and amortisation** | 5,201 | 2,573 | — | | 2,573 | 7,774 |
| Profit on property developments | 5,817 | — | — | | — | 5,817 |
| **Operating profit before depreciation and amortisation** | 11,018 | 2,573 | — | | 2,573 | 13,591 |
| Depreciation and amortisation | (2,674) | (11) | (312) | *3(i)* | (323) | (2,997) |
| **Operating profit before interest and finance charges** | 8,344 | 2,562 | (312) | | 2,250 | 10,594 |
| Interest and finance charges | (1,398) | — | (1,298) | *3(ii)* | (1,298) | (2,696) |
| Change in fair value of investment properties | 2,178 | — | — | | — | 2,178 |
| Share of profit less losses of non-controlled subsidiaries and associates | 45 | — | — | | — | 45 |
| **Profit before taxation** | 9,169 | 2,562 | (1,610) | | 952 | 10,121 |
| Income tax | (1,411) | (448) | 282 | *3(iii)* | (166) | (1,577) |
| **Profit for the year** | 7,758 | 2,114 | (1,328) | | 786 | 8,544 |
| **Attributable to:** | | | | | | |
| - Equity shareholders of the Company | 7,759 | 2,114 | (1,328) | | 786 | 8,545 |
| - Minority interests | (1) | — | — | | — | (1) |
| **Profit for the year** | 7,758 | 2,114 | (1,328) | | 786 | 8,544 |
| **Earnings per share** | | | | | | |
| **- Basic** | **$1.41** | | | | **$0.14** | **$1.55** |
| **- Diluted** | **$1.41** | | | | **$0.14** | **$1.55** |
| *Profit attributable to equity shareholders from underlying business before changes in fair value of investment properties net of related deferred tax* | *5,962* | | | | | *6,748* |
| *Earnings per share before changes in fair value of investment properties net of related deferred tax* | *$1.08* | | | | | *$1.22* |

## (III) Unaudited pro forma combined profit and loss account of the Enlarged Group For the period ended 30 June 2007

| | Consolidated Profit and Loss Account of MTRC | Adjusted Consolidated Profit and Loss Account of KCRC | Unaudited Pro forma Adjustments | | Total Adjustments | Combined Profit and Loss Account of Enlarged Group Pro forma Total |
|---|---|---|---|---|---|---|
| | *HK$ million* | *HK$ million* | *HK$ million* | | *HK$ million* | *HK$ million* |
| | *Note 1* | *Note 2* | | *Note 4* | | |
| Fare revenue | 3,247 | 2,295 | — | | 2,295 | 5,542 |
| Non-fare and rental and management income | 1,605 | 534 | — | | 534 | 2,139 |
| **Turnover** | 4,852 | 2,829 | — | | 2,829 | 7,681 |
| **Operating expenses before depreciation and amortisation** | (2,055) | (1,540) | — | | (1,540) | (3,595) |
| **Operating profit from railway and related operations before depreciation and amortisation** | 2,797 | 1,289 | — | | 1,289 | 4,086 |
| Profit on property developments | 1,664 | — | — | | — | 1,664 |
| **Operating profit before depreciation and amortisation** | 4,461 | 1,289 | — | | 1,289 | 5,750 |
| Depreciation and amortisation | (1,348) | (7) | (156) | *4(i)* | (163) | (1,511) |
| **Operating profit before interest and finance charges** | 3,113 | 1,282 | (156) | | 1,126 | 4,239 |
| Interest and finance charges | (654) | — | (619) | *4(ii)* | (619) | (1,273) |
| Change in fair value of investment properties | 2,450 | — | 492 | *4(iii)* | 492 | 2,942 |
| Share of profit less losses of non-controlled subsidiaries and associates | 42 | — | — | | — | 42 |
| **Profit before taxation** | 4,951 | 1,282 | (283) | | 999 | 5,950 |
| Income tax | (879) | (225) | 50 | *4(iv)* | (175) | (1,054) |
| **Profit for the period** | 4,072 | 1,057 | (233) | | 824 | 4,896 |
| **Attributable to:** | | | | | | |
| - Equity shareholders of the Company | 4,071 | 1,057 | (233) | | 824 | 4,895 |
| - Minority interests | 1 | — | — | | — | 1 |
| **Profit for the period** | 4,072 | 1,057 | (233) | | 824 | 4,896 |
| **Earnings per share** | | | | | | |
| **- Basic** | **$0.73** | | | | **$0.15** | **$0.88** |
| **- Diluted** | **$0.73** | | | | **$0.15** | **$0.88** |
| *Profit attributable to equity shareholders from underlying business before changes in fair value of investment properties net of related deferred tax* | *2,050* | | | | | *2,468* |
| *Earnings per share before changes in fair value of investment properties net of related deferred tax* | *$0.37* | | | | | *$0.44* |

## (IV) Unaudited pro forma combined cash flow statement of the Enlarged Group For the year ended 31 December 2006

| | Consolidated Cash Flow Statement of MTRC HK$ million Note 1 | Adjusted Consolidated Cash Flow Statement of KCRC HK$ million Note 2 | Unaudited Pro forma Adjustments HK$ million | Note 5 | Total Adjustments HK$ million | Combined Cash Flow Statement of Enlarged Group Pro forma Total HK$ million |
|---|---|---|---|---|---|---|
| **Cash flows from operating activities** | | | | | | |
| Operating profit from railway and related businesses before depreciation | 5,201 | 2,573 | — | | 2,573 | 7,774 |
| Adjustments for non-cash items | 68 | 63 | — | | 63 | 131 |
| Operating profit from railway and related businesses before working capital changes | 5,269 | 2,636 | — | | 2,636 | 7,905 |
| Changes in working capital | 121 | 84 | 614 | 5(i) | 698 | 819 |
| Cash generated from operations | 5,390 | 2,720 | 614 | | 3,334 | 8,724 |
| Profits tax paid | (3) | (1) | — | | (1) | (4) |
| *Net cash inflow from operating activities* | 5,387 | 2,719 | 614 | | 3,333 | 8,720 |
| **Cash flows from investing activities** | | | | | | |
| Capital expenditure | (2,903) | (389) | — | | (389) | (3,292) |
| Merger | | | | | | |
| - Upfront payment for Service Concession | — | — | (4,250) | 5(ii) | (4,250) | (4,250) |
| - Upfront payment for Property Package | — | — | (7,790) | 5(ii) | (7,790) | (7,790) |
| - Fixed annual payment | — | — | (750) | 5(ii) | (750) | (750) |
| - Other expenditure | (88) | — | (375) | 5(ii) | (375) | (463) |
| Receipts in respect of property development | 4,400 | — | 66 | 5(iii) | 66 | 4,466 |
| Loan to a property developer | (4,000) | — | — | | — | (4,000) |
| Receipts on sales of fixed assets | — | 5 | — | | 5 | 5 |
| Other investments | (179) | — | — | | — | (179) |
| *Net cash outflow from investing activities* | (2,770) | (384) | (13,099) | | (13,483) | (16,253) |
| **Cash flows from financing activities** | | | | | | |
| Proceeds from shares issued | 36 | — | — | | — | 36 |
| Net drawdown of loans and capital market instruments | 229 | — | 10,722 | 5(iv) | 10,722 | 10,951 |
| Reduction in capital element of finance lease | (131) | — | — | | — | (131) |
| Net interest and finance charges paid | (1,636) | — | (572) | 5(v) | (572) | (2,208) |
| Dividends paid | (1,155) | — | — | | — | (1,155) |
| *Net cash (outflow)/inflow from financing activities* | (2,657) | — | 10,150 | | 10,150 | 7,493 |
| Net (decrease)/increase in cash and cash equivalents | (40) | 2,335 | (2,335) | 5(vi) | — | (40) |
| Cash and cash equivalents at 1 January | 345 | 111 | (111) | | — | 345 |
| Cash and cash equivalents at 31 December | 305 | 2,446 | (2,446) | | — | 305 |

### (V) Unaudited pro forma combined cash flow statement of the Enlarged Group For the period ended 30 June 2007

| | Consolidated Cash Flow Statement of MTRC | Adjusted Consolidated Cash Flow Statement of KCRC | Unaudited Pro forma Adjustments | | Total Adjustments | Combined Cash Flow Statement of Enlarged Group Pro forma Total |
|---|---|---|---|---|---|---|
| | *HK$ million* | *HK$ million* | *HK$ million* | | *HK$ million* | *HK$ million* |
| | *Note 1* | *Note 2* | | *Note 6* | | |
| **Cash flows from operating activities** | | | | | | |
| Operating profit from railway and related businesses before depreciation | 2,797 | 1,289 | — | | 1,289 | 4,086 |
| Adjustments for non-cash items | 21 | 32 | — | | 32 | 53 |
| Operating profit from railway and related businesses before working capital changes | 2,818 | 1,321 | — | | 1,321 | 4,139 |
| Changes in working capital | 164 | 181 | — | | 181 | 345 |
| Cash generated from operations | 2,982 | 1,502 | — | | 1,502 | 4,484 |
| Profits tax paid | (1) | (1) | — | | (1) | (2) |
| *Net cash inflow from operating activities* | 2,981 | 1,501 | — | | 1,501 | 4,482 |
| **Cash flows from investing activities** | | | | | | |
| Capital expenditure | (1,062) | (170) | — | | (170) | (1,232) |
| Merger | | | | | | |
| - Upfront payment for Service Concession | — | — | — | | — | — |
| - Upfront payment for Property Package | — | — | — | | — | — |
| - Fixed annual payment | — | — | — | | — | — |
| - Other expenditure | (50) | — | — | | — | (50) |
| Receipts in respect of property development | 3,136 | — | — | | — | 3,136 |
| Loan to a property developer | — | — | — | | — | — |
| Receipts on sales of fixed assets | — | — | — | | — | — |
| Other investments | (165) | — | — | | — | (165) |
| *Net cash inflow/(outflow) from investing activities* | 1,859 | (170) | — | | (170) | 1,689 |
| **Cash flows from financing activities** | | | | | | |
| Proceeds from shares issued | 6 | — | — | | — | 6 |
| Net repayment of loans and capital market instruments | (3,107) | — | (1,074) | *6(i)* | (1,074) | (4,181) |
| Reduction in capital element of finance lease | (69) | — | — | | — | (69) |
| Net interest and finance charges paid | (786) | — | (257) | *6(ii)* | (257) | (1,043) |
| Dividends paid | (777) | — | — | | — | (777) |
| *Net cash outflow from financing activities* | (4,733) | — | (1,331) | | (1,331) | (6,064) |
| Net increase/(decrease) in cash and cash equivalents | 107 | 1,331 | (1,331) | *6(i)* | — | 107 |
| Cash and cash equivalents at 1 January | 305 | 2,446 | (2,446) | | — | 305 |
| Cash and cash equivalents at 30 June | 412 | 3,777 | (3,777) | | — | 412 |

## (VI) Unaudited pro forma combined balance sheet of the Enlarged Group As at 30 June 2007

| | Consolidated Balance Sheet of MTRC | Adjusted Consolidated Balance Sheet of KCRC | Unaudited Pro forma Adjustments | Total Adjustments | | Combined Balance Sheet of Enlarged Group Pro forma Total |
|---|---|---|---|---|---|---|
| | *HK$ million* | *HK$ million* | *HK$ million* | *HK$ million* | | *HK$ million* |
| | *Note 1* | *Note 2* | | | *Note 7* | |
| **Assets** | | | | | | |
| Fixed assets | | | | | | |
| - Investment properties | 25,013 | 1,544 | 1,810 | 3,354 | *7(i)* | 28,367 |
| - Other property, plant and equipment | 83,812 | 34 | 155 | 189 | *7(ii)* | 84,001 |
| - Service concession asset | — | — | 15,335 | 15,335 | *7(iii)* | 15,335 |
| | 108,825 | 1,578 | 17,300 | 18,878 | | 127,703 |
| Property management rights | — | — | 40 | 40 | *7(iv)* | 40 |
| Railway construction in progress | 276 | — | — | — | | 276 |
| Property development in progress | 3,200 | — | 5,785 | 5,785 | *7(v)* | 8,985 |
| Loan to a property developer | 3,442 | — | — | — | | 3,442 |
| Debtors, deposits and payments in advance | 1,957 | 2 | 19 | 21 | *7(vi)* | 1,978 |
| Stores and spares | 277 | 355 | 12 | 367 | *7(vii)* | 644 |
| Other assets | 4,644 | 2 | (212) | (210) | *7(viii)* | 4,434 |
| Cash and cash equivalents | 413 | 150 | — | 150 | *7(ix)* | 563 |
| | 123,034 | 2,087 | 22,944 | 25,031 | | 148,065 |
| **Liabilities** | | | | | | |
| Loans and other financing | 25,170 | — | 11,277 | 11,277 | *7(x)* | 36,447 |
| Deferred income | 1,226 | 33 | 66 | 99 | *7(xi)* | 1,325 |
| Deferred tax liabilities | 10,374 | — | 86 | 86 | *7(xii)* | 10,460 |
| Other liabilities | 5,967 | 888 | 12,270 | 13,158 | *7(xiii)* | 19,125 |
| | 42,737 | 921 | 23,699 | 24,620 | | 67,357 |
| **Net assets** | 80,297 | 1,166 | (755) | 411 | | 80,708 |
| **Capital and reserves** | | | | | | |
| Share capital, share premium and capital reserve | 39,421 | — | — | — | | 39,421 |
| Other reserves | 40,856 | 1,166 | (755) | 411 | | 41,267 |
| **Total equity attributable to equity shareholders of the company** | 80,277 | 1,166 | (755) | 411 | | 80,688 |
| **Minority interests** | 20 | — | — | — | | 20 |
| **Total equity** | 80,297 | 1,166 | (755) | 411 | | 80,708 |

**(VII) Notes to the unaudited Pro Forma Financial Information**

Note 1 : The profit and loss account, balance sheet and cash flow statement of MTRC are extracted from the 2007 and 2006 Interim Report, and the 2006 Annual Report of the Group which were prepared in accordance with the applicable Hong Kong Financial Reporting Standards ("HKFRSs") and applicable disclosure provisions of the Listing Rules.

Note 2 : Under the proposed Rail Merger, certain agreements are to be entered into with regard to the KCRC business and operations (collectively referred to as "Transaction Documents") as set out below. The terms of the proposed Rail Merger as prescribed in the Transaction Documents, are such that MTRC will acquire substantially all the business operations of KCRC and the residual operations of KCRC post merger would predominantly be of an administrative nature only.

The Transaction Documents include:

- Service Concession Agreement ("SCA") in respect of the grant to MTRC of the rights to access, use and operate the Hong Kong section of the Kowloon-Canton Railway ("railway network") for a specified term.

- Property Package Agreements whereby property assets comprising certain investment and own-use properties, property management rights and property development rights (collectively referred to as the "Property Package") currently held by KCRC are to be acquired by MTRC.

- Merger Framework Agreement in respect of the proposed framework for the Rail Merger.

Under the terms of the SCA, the tangible assets that form part of the railway network are subject to a service concession arrangement whereby MTRC will have the right to access, use and operate these assets. These tangible assets comprise of tangible assets that exist on the date of the proposed Rail Merger ("Initial Concession Property") and those assets that are subsequently acquired after the date of the proposed Rail Merger ("Additional Concession Property"). Ownership of the Initial Concession Property will remain with KCRC. As the Initial Concession Property assets will not be acquired by MTRC under the terms of the Transaction Documents, they will continue to form part of KCRC's fixed assets. Under HK(IFRIC) 12 *"Service Concession Arrangements",* MTRC would not recognise such railway assets on its balance sheet and would recognise a service concession asset in respect of payments to acquire the right to operate the railway assets of KCRC. Accordingly, the railway assets of KCRC would remain recognised in KCRC's financial statements as fixed assets.

Under the Transaction Documents, certain specified assets and liabilities are not included in the proposed arrangements. The railway construction in progress relating to the East Rail Extension and the Kowloon Southern Link which will continue to be funded by KCRC, the deferred expenditure relating to the Shatin to Central Link and the Northern Link / Express Rail, the debt and cross-border leases of KCRC, cash balances of KCRC (apart from cash balances in subsidiaries to be acquired) prior to the Merger Date, the investment in Octopus Holdings Limited, the West Rail property subsidiaries and certain property arrangements are excluded from the terms of the Transaction Documents. In addition, deferred taxation is not included in the Transaction Documents and does not form part of the arrangements.

The financial information contained in the Proforma Financial Information under the columns "Adjusted Consolidated Profit and Loss Account of KCRC", "Adjusted Consolidated Balance Sheet of KCRC", and "Adjusted Consolidated Cash Flow Statement of KCRC", is extracted from the financial statements of KCRC for the year ended 31 December 2006, and the six months ended 30 June 2007 and is adjusted for those revenues, expenditures, assets and liabilities which are not subject to the terms of the Transaction Documents. Note 44 on "Additional Financial Information" to the Accountants' Report in Appendix V to this Circular sets out further financial information in this regard.

Note 3 : The following unaudited pro forma adjustments have been made to the unaudited pro forma combined profit and loss account of the Enlarged Group for the year ended 31 December 2006 as if the proposed Rail Merger was effected on 1 January 2006 including:

(i) Recognition of the annual amortisation charge amounting to HK$312 million representing the amortisation charge of the service concession asset of HK$308 million, and the amortisation charge of existing property management rights of HK$4 million.

(ii) Recognition of the interest expense of HK$572 million relating to the additional loan financing, loan finance charges of HK$5 million in respect of the additional loan facility, and the finance charge of HK$721 million relating to the capitalised amount of HK$10,687 million included in service concession asset in respect of the net present value of the fixed annual payments of HK$750 million per annum over the Concession Period.

(iii) Recognition of the tax effect on the proforma adjustments using a standard rate of 17.5%.

Note 4 : The following unaudited pro forma adjustments have been made to the unaudited pro forma combined profit and loss account of the Enlarged Group for the six months period from 1 January 2007 to 30 June 2007 which has been prepared on a continuing basis as if the proposed Rail Merger was effected on 1 January 2006 including:

(i) Recognition of the amortisation charge amounting to HK$156 million representing the amortisation charge of the service concession asset of HK$154 million, and the amortisation charge of existing property management rights of HK$2 million for the six months period.

(ii) Recognition of the interest expense of HK$257 million relating to the additional loan financing, loan finance charges of HK$2 million in respect of the additional loan facility, and the finance charge of HK$360 million relating to the capitalised amount of HK$10,687 million included in service concession asset in respect of the net present value of the fixed annual payments of HK$750 million per annum over the Concession Period.

(iii) Recognition of the increase in the fair value of the investment properties acquired by the Company over the cost of acquisition based on the external valuations performed by Jones Lang LaSalle, an independent firm of surveyors which has among its staff Fellow and Associate members of the Hong Kong Institute of Surveyors and The Royal Institution of Chartered Surveyors (refer to Appendix VIII).

(iv) Recognition of the tax effect on the pro forma adjustments using a standard rate of 17.5%.

Note 5 : The following unaudited pro forma adjustments have been made to the unaudited proforma combined cash flow statement of the Enlarged Group for the year ended 31 December 2006 as if the proposed Rail Merger was effected on 1 January 2006 including:

(i) Adjustments of HK$614 million represent certain liabilities transferred from KCRC of HK$503 million and certain other liabilities taken over by the Company in respect of certain acquired subsidiaries of KCRC of HK$111 million.

(ii) Represents upfront payment in respect of service concession assets of HK$4,250 million, payment in relation to the acquisition of the property package of HK$7,790 million, fixed annual payment of HK$750 million, and payment in respect of other costs directly attributable to the proposed Rail Merger.

(iii) Represents the cash reimbursement from KCRC in respect of the excess mandatory payment relating to Tai Wai Maintenance Centre.

(iv) Adjustment of HK$10,722 million represents the net drawdown of the additional loan financing as follows:

| | *HK$ million* |
|---|---|
| - Upfront payment on concession assets | 4,250 |
| - Payment for Property Package | 7,790 |
| - Stamp Duty, upfront loan financing charge | 40 |
| - Payment of fixed annual payment | 750 |
| - Cash balances transferred from KCRC on the acquisition of certain KCRC subsidiaries by the Company | (111) |
| - Assumption by the Company of certain obligations with cash settlement | (503) |
| - Settlement of certain obligations of KCRC assumed by the Company | 335 |
| - Cash reimbursement from KCRC on excess mandatory payment relating to Tai Wai Maintenance Centre | (66) |
| - Payment of the interest expense for the year (refer note 5(v)) | 572 |
| | 13,057 |
| - Net of loan repayment arising from cash inflows generated during the year (Note 5(v)) | (2,335) |
| | 10,722 |

(v) Represents payment of interest expense of HK$572 million relating to the additional loan financing (refer note 5(iv)).

(vi) Represents cash inflows generated since the Merger Date from the relevant KCRC Business used to partially repay the additional loan financing.

Note 6 : The following unaudited pro forma adjustments have been made to the unaudited pro forma combined cash flow statement of the Enlarged Group for the six months period from 1 January 2007 to 30 June 2007 which has been prepared on a continuing basis as if the proposed Rail Merger was effected on 1 January 2006 including:

(i) Cash inflows generated since the Merger Date for the period from 1 January 2007 to 30 June 2007 from the relevant KCRC Business used to partially repay the additional loan financing.

(ii) Represents payment of interest expense of HK$257 million relating to the additional loan financing.

Note 7 : The following unaudited pro forma adjustments have been made to the unaudited pro forma combined balance sheet of the Enlarged Group as at 30 June 2007 as if the proposed Rail Merger was effected on 30 June 2007 including:

(i) Acquisition of certain investment properties and own-use properties from KCRC for a total consideration of HK$2,840 million and stamp duty thereon of HK$22 million, which is analysed further as follows:

| | *HK$ million* |
|---|---|
| Consideration payable by the Company | 2,840 |
| Add: Stamp duty | 22 |
| Cost of acquisition | 2,862 |
| Change in fair value of investment properties (refer note 4(iii)) | 492 |
| | 3,354 |

(ii) The adjustment of HK$189 million represents:

| | *HK$ million* |
|---|---|
| Acquisition of assets relating to V-Connect | 34 |
| Capitalisation of merger related costs of a capital nature relating to plant and equipment | 155 |
| | 189 |

(iii) Recognition of a service concession asset at carrying value of HK$15,335 million upon application of HK(IFRIC) 12 "Service Concession Arrangements" in respect of:

- the acquisition of initial concession assets of HK$14,847 million which comprise of
  - upfront payment of HK$3,895 million (HK$4,250 million less consideration of HK$355 million for the acquisition of certain stores and spares (refer note 7(vii));
  - the net present value of the fixed annual payments of HK$750 million discounted at an interest rate of 6.75%, which is the estimated incremental cost of borrowing for the Company for the long-term, amounting to HK$10,687 million (note 7(xiii));
  - the assumption of certain obligations of KCRC in the amounts of HK$265 million by the Company forming part of the cost of acquiring the service concession asset;
- the capitalisation of costs of HK$389 million previously incurred by the Company and classified as "deferred expenditure" which are directly attributable to the cost of acquiring the service concession asset; and
- the assumption of certain liabilities of a capital nature amounting to HK$99 million representing additional concession property acquired on the merger date.

(iv) Acquisition of property management rights from KCRC for a consideration of HK$40 million representing existing and future property management rights and which is to be amortised over the period of the property management rights of two years accordingly.

(v) Acquisition of property development rights as detailed in Appendix III by the Group from KCRC for a consideration of HK$4,910 million and the recognition of mandatory payments amounting to HK$875 million that are payable to KCRC in respect of the sites subject to the property development rights (refer note 7(xiii)).

(vi) Recognition of the prepaid loan finance costs of HK$19 million in relation to the additional loan financing and assumed debtors relating to the acquisition by the Company of certain KCRC subsidiaries of HK$2 million.

(vii) Acquisition of stores and spares at inception of the proposed Rail Merger by the Group from KCRC (refer note 7(iii)).

(viii) Reclassification of costs previously incurred and classified as "deferred expenditure" amounting to HK$212 million to service concession asset and other property, plant and equipment on merger date, and deferred tax asset of HK$2 million assumed by the Company in respect of the acquisition of a KCRC subsidiary.

(ix) Represents cash balances of HK$150 million transferred by KCRC to the Company in respect of certain liabilities assumed by the Company on the acquisition of certain KCRC subsidiaries.

(x) The adjustment of HK$11,277 million represents:

| | *HK$ million* |
|---|---|
| Additional loans drawn for acquisition of:- | |
| - Concession assets (refer note 7(iii)) | 4,250 |
| - Property development rights (refer note 7(v)) | 4,910 |
| - Investment property (refer note 7(i)) | 2,840 |
| - Property management rights (existing and future) (refer note 7(iv)) | 40 |
| - Stamp duty | 22 |
| - Initial fee on additional loan financing | 19 |
| - Cash reimbursement on excess mandatory payment | (66) |
| - Cash settlement of certain liabilities transferred from KCRC to the Company on Merger Date | (738) |
| | 11,277 |

(xi) Deferred income represents cash receipts from telecommunication operators for the lease of telecommunication networks of HK$33 million and HK$66 million in respect of excess upfront mandatory payment received in respect of Tai Wai Maintenance Centre.

(xii) Recognition of the deferred tax effect in respect of the change in fair value of investment properties on the Merger Date using a standard rate of 17.5%

(xiii) The adjustment of HK$13,158 million relates to the following:

| | *Note* | *HK$ million* |
|---|---|---|
| - Accruals in respect of merger costs incurred up to the Merger Date | | 332 |
| - Assumption by the Company of certain KCRC obligations on Merger Date | (a) | 376 |
| - Recognition of mandatory payments payable to KCRC in respect of the sites subject to the property development rights (refer note 7(v)) | | 875 |
| - The net present value of the fixed annual payments of HK$750 million discounted at an interest rate of 6.75%, which is the estimated incremental cost of borrowing for the Company in the long term (refer note 7(iii)) | | 10,687 |
| - Transfer of certain liabilities of KCRC with cash settlement on the Merger Date | (b) | 888 |
| | | 13,158 |

(a) The adjustment of HK$376 million represents the assumption by the Company of certain KCRC obligations on Merger Date as follows:

| | HK$ million |
|---|---|
| - Accrued annual leave | 70 |
| - Accounts payables in respect of stores and spares assumed on merger date | 12 |
| - Accrued liabilities of a capital nature assumed by the Company on merger date | 99 |
| - Other obligations of KCRC assumed by the Company on merger date | 195 |
| | 376 |

(b) The adjustment of HK$888 million represents the transfer of the following obligations of KCRC to the Company with cash settlement on the Merger Date:

| | HK$ million |
|---|---|
| - Certain deposits and advances | 629 |
| - Certain obligations of acquired KCRC subsidiaries | 150 |
| - Certain accrued KCRC staff obligations | 109 |
| | 888 |

Note 8: In the preparation of the pro-forma financial information of the Enlarged Group, the fare reduction, the fare adjustment mechanism, variable annual payments and synergies are considered to be related to future events or decisions and accordingly are not considered as adjustments under Rule 4.29(6) of the Listing Rules and therefore have not been taken into account in the preparation of the unaudited pro forma financial information. Further details are set out below.

(i) Fare Adjustment Mechanism and Fare reduction

The Company and the Government have agreed upon a formulaic approach for determining future fare adjustments. Details of the fair adjustment mechanism ("FAM") and the calculation formula are contained in the paragraph headed "Operating Agreement" in the Appendix to this Circular headed "Transaction Documents" and the section headed "Letter from the Board".

The Directors estimate, on the basis that the FAM comes into effect on 1 July 2006, that the application of the FAM formula, applying the relevant indices for December 2005 to the estimated relevant fare revenues for the respective periods, would give rise to a potential fare increase of approximately +1.35% which is below the ±1.5% threshold required for implementation. Under the FAM, adjustments not applied in any year, as a result of being below the ±1.5% threshold, could be carried over to be applied to the following year's FAM calculation.

In addition, the Directors estimate the impact of the fare reduction pursuant to the Rail Merger would be HK$600 million for the year ended 31 December 2006 and HK$300 million for the six months period ended 30 June 2007.

(ii) Variable Annual Payment

The Company is obliged to pay a Variable Annual Payment ("VAP") calculated as a tiered percentage of revenue generated from the KCRC System with reference to certain thresholds as defined in the Service Concession Agreement. Details of the Variable Annual Payment and the calculation formula are contained in the Appendix III to this Circular headed "Transaction Documents" and the section headed "Letter from the Board". The VAP will be payable by the Company annually in arrears and charged to the profit and loss account as incurred. No VAP shall be payable in respect of the first three years after the Rail Merger becomes effective. No adjustment has been made in the pro forma financial information in respect of the VAP.

No VAP is payable by the Company in respect of the first three years. VAP is calculated on the basis of applying the formula to the relevant revenues from the KCRC System for the respective years, which the directors estimate to be approximately HK$5,200 million for the year ended 31 December 2006. On the basis of the directors' estimate, the estimated VAP would represent approximately 5.4% of the estimated relevant revenue of the KCRC System for the year ended 31 December 2006.

(iii) Synergies

For the avoidance of doubt, in the preparation of the unaudited pro forma financial information, no adjustments have been taken into account for any synergies which may be effected in the future.

## (B) REPORT ON UNAUDITED PRO FORMA FINANCIAL INFORMATION

*The following is the full text of a report, prepared for the purpose of incorporation in this circular, received from the independent reporting accountants of the Company, KPMG, Certified Public Accountants, Hong Kong. As described in the paragraph headed "Documents Available for Inspection" in Appendix IX, a copy of the report is available for inspection.*

KPMG

8th Floor
Prince's Building
10 Chater Road
Central
Hong Kong

3 September 2007

The Board of Directors
MTR Corporation Limited

Dear Sirs,

We report on the unaudited pro forma combined profit and loss accounts, the unaudited pro forma combined cash flow statements and the unaudited pro forma combined balance sheet set out in Section A of Appendix VII to the circular of MTR Corporation Limited (the "Company") (the "Unaudited Pro Forma Financial Information"), which has been prepared by the directors of the Company for illustrative purposes only, to provide information on how the agreements to be entered into by the Company in relation to the proposed merger with KCRC, including the Service Concession Agreement, the Property Package Agreements, and the Merger Framework Agreement, might have affected the consolidated profit and loss account and consolidated cash flow statement of the Company and its subsidiaries (hereinafter collectively referred to as the "Group") for the year ended 31 December 2006 and the six months ended 30 June 2007 and the consolidated balance sheet of the Group as at 30 June 2007. The basis of preparation of the Unaudited Pro Forma Financial Information is set out in the introduction and the notes to the unaudited Pro Forma Financial Information of the Enlarged Group as set out in Appendix VII of the Circular.

**Responsibilities**

It is solely the responsibility of the directors of the Company to prepare the Unaudited Pro Forma Financial Information in accordance with Paragraph 29 of Chapter 4 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the "Listing Rules") and with reference to Accounting Guideline 7 "Preparation of Pro Forma Financial Information for Inclusion in Investment Circulars" issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA").

It is our responsibility to form an opinion, as required by Paragraph 29(7) of Chapter 4 of the Listing Rules, on the Unaudited Pro Forma Financial Information and to report our opinion to you. We do not accept any responsibility for any reports previously given by us on any financial information used in the compilation of the Unaudited Pro Forma Financial Information beyond that owed to those to whom those reports were addressed by us at the dates of their issues.

**Basis of opinion**

We conducted our work in accordance with Hong Kong Standard on Investment Circular Reporting Engagements 300 "Accountants' Reports on Pro Forma Financial Information in Investment Circulars" issued by the HKICPA. Our work consisted primarily of comparing the unadjusted financial information with the source documents, considering the evidence supporting the adjustments and discussing the Unaudited Pro Forma Financial Information with the directors of the Company. The engagement did not involve independent examination of any of the underlying financial information.

We planned and performed our work so as to obtain the information and explanations we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the Unaudited Pro Forma Financial Information has been properly compiled by the directors of the Company on the basis stated, that such basis is consistent with the accounting policies of the Group and that the adjustments are appropriate for the purpose of the Unaudited Pro Forma Financial Information as disclosed pursuant to Paragraph 29(1) of Chapter 4 of the Listing Rules.

The Unaudited Pro Forma Financial Information is for illustrative purposes only, based on the judgements and assumptions of the directors of the Company, and because of its hypothetical nature, it does not provide any assurance or indication that any event will take place in the future and may not be indicative of:

- The results and cash flows of the Enlarged Group for the year ended 31 December 2006, six months ended 30 June 2007 or any future periods; or

- The financial position of the Enlarged Group as at 30 June 2007 or any future date.

**Opinion**

In our opinion:

(a) the Unaudited Pro Forma Financial Information has been properly compiled by the directors of the Company on the basis stated;

(b) such basis is consistent with the principal accounting policies of the Group; and

(c) the adjustments are appropriate for the purposes of the Unaudited Pro Forma Financial Information as disclosed pursuant to Paragraph 29(1) of Chapter 4 of the Listing Rules.

Yours faithfully
**KPMG**
*Certified Public Accountants*
Hong Kong

## (C) INDEBTEDNESS STATEMENT OF THE ENLARGED GROUP

As at the close of business on 30 June 2007, the Enlarged Group had unsecured outstanding borrowings as follows:

| *in HK$ million* | The Group | Additional Borrowing Requirement | Enlarged Group |
|---|---|---|---|
| **Capital market instruments** | | | |
| Listed or publicly traded: | | | |
| US dollar Global notes due 2009 | 5,718 | — | 5,718 |
| US dollar Global notes due 2010 | 4,607 | — | 4,607 |
| Debt issuance programme (Eurobond due 2014) | 4,510 | — | 4,510 |
| | 14,835 | — | 14,835 |
| Unlisted: | | | |
| Debt issuance programme notes due 2008 to 2020 | 6,960 | — | 6,960 |
| HK dollar notes due 2008 | 508 | — | 508 |
| | 7,468 | — | 7,468 |
| **Total capital market instruments** | 22,303 | — | 22,303 |
| **Bank loans** | 2,770 | 11,277* | 14,047 |
| **Obligations under finance leases** | 72 | — | 72 |
| | 25,145 | 11,277 | 36,422 |
| **Bank overdrafts** | 1 | — | 1 |
| **Short-term loans** | 24 | — | 24 |
| **Total** | 25,170 | 11,277 | 36,447 |

| **By repayment terms** *in HK$ million* | Capital market instruments | Bank loans and overdrafts | Obligations under finance leases | Total |
|---|---|---|---|---|
| **Long-term loans and obligations under finance leases** | | | | |
| Amounts repayable beyond 5 years | 10,110 | — | — | 10,110 |
| Amounts repayable within a period of between 2 and 5 years | 5,829 | 1,739 | — | 7,568 |
| Amounts repayable within a period of between 1 and 2 years | 5,834 | 630 | — | 6,464 |
| Amounts repayable within 1 year | 1,000 | 370 | 72 | 1,442 |
| | 22,773 | 2,739 | 72 | 25,584 |
| **Bank overdrafts** | — | 1 | — | 1 |
| **Short-term loans** | — | 24 | — | 24 |
| **Repayable amount** | 22,773 | 2,764 | 72 | 25,609 |
| Less: Unamortised discount/premium/ finance changes outstanding | | | | (115) |
| Adjustment due to fair value change of financial instruments | | | | (324) |
| **Carrying amount outstanding** | | | | 25,170 |
| Additional borrowing requirement | | | | 11,277 |
| **Pro forma debt position of the Enlarged Group** | | | | 36,447 |

* *Pursuant to the Rail Merger, the Enlarged Group is anticipated to raise additional loans in aggregate amounts of HK$11,277 million and details of which are set out in note 7(x) of Appendix VII "Financial Information of the Enlarged Group" to the Circular. This will increase the total borrowings from HK$25,170 million as at 30 June 2007 to HK$36,447 million on an unaudited pro forma basis.*

The total repayable amount of debt outstanding as at 30 June 2007 comprised local currency debts and foreign currency debts. Foreign currency debts hedged into Hong Kong Dollars were translated at their respective contract rates. Unhedged foreign currency debts were translated into Hong Kong dollars at the exchange rate prevailing at the close of business on 30 June 2007. As at 30 June 2007, unhedged foreign currency debts amounted to approximately 0.2% of the total debts outstanding.

As at 30 June 2007, the Group had available undrawn committed bank loan facilities amounting to HK$6,300 million. In addition, the Group had a number of uncommitted facilities with undrawn amounts totalling HK$16,521 million, comprising a debt issuance programme of HK$11,657 million and short-term bank loan facilities of HK$4,864 million.

As at 30 June 2007, the Group has outstanding capital commitments, operating lease commitments and guarantees as disclosed in note 46 of the Financial Information of the Group set out in Appendix IV to this Circular.

Pursuant to the Rail Merger, the Enlarged Group is obliged to pay a Fixed Annual Payment of HK$750 million over the period of the Service Concession. At 30 June 2007, the net present value of the Fixed Annual Payments over the concession period amount to HK$10,687 million. In addition, the Enlarged Group is obliged to pay a Variable Annual Payment ("VAP") calculated as a percentage of revenue generated from the KCRC System with reference to certain thresholds as defined in the Service Concession Agreement. The VAP will be payable by the Company annually in arrears and charged to the profit and loss account as incurred. No VAP shall be payable in respect of the first three years after the Rail Merger becomes effective.

Pursuant to the Rail Merger, the Company shall agree to be jointly liable (together with KCRC) to various counterparties of KCRC in respect of KCRC's obligations under KCRC's US cross border leases ("CBLs"). Obligations under the CBLs which, as between the Company and KCRC, the Company agrees to be responsible for are "MTRC Obligations". The Company shall indemnify each of the Government and KCRC for losses, and for reasonable costs incurred, arising from or in connection with the Company not complying with the MTRC Obligations. The indemnity shall not extend to losses and costs which arise out of or in relation to Government's or KCRC's own fraud, negligence or bad faith, or breach of the Transaction Documents.

KCRC and the Government shall indemnify the Company for losses, and for reasonable costs incurred, arising from or in connection with the due and proper performance by the Company of the MTRC Obligations. KCRC will indemnify the Company for losses, and for reasonable costs incurred, arising from or in connection with KCRC not complying with its obligations under the CBLs other than the MTRC Obligations. The indemnities shall not extend to costs or expenses which the Company would have incurred in any event in respect of the relevant Concession Property (regardless of whether or not such property were subject to the terms of the CBLs); or to losses and costs which arise out of or in relation to the Company's own fraud, negligence or bad faith, or breach of the Transaction Documents.

As at 30 June 2007, the Group considered that it had no other disclosable contingent liabilities as there were neither pending litigations nor events with potential obligation which were probable to result in material outflow of economic benefits to the group.

Save as disclosed above and apart from intra-group liabilities, the Enlarged Group did not have any debt securities issued and outstanding or authorised or otherwise created but unissued, any other term loans (secured, unsecured, guaranteed or not), any other borrowings or indebtedness in the nature of borrowing including bank overdrafts and liabilities under acceptance or acceptance credits or hire purchase commitments (whether secured/unsecured, guaranteed or not), any other mortgages and charges, and any other material contingent liabilities at the close of business on 30 June 2007.

The Directors have confirmed that there have been no material changes in the indebtedness and contingent liabilities of the Enlarged Group since 30 June 2007, up to and including the Latest Practicable Date.

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3 September 2007

The Board of Directors
MTR Corporation Limited
MTR Tower
Telford Plaza
Kowloon Bay
Hong Kong

Dear Sirs

RE: VALUATION OF PROPERTY PORTFOLIOS OF MTR CORPORATION LIMITED AND KOWLOON-CANTON RAILWAY CORPORATION

## 1.0 INTRODUCTION

### 1.1 Instructions

We refer to the instructions received from MTR Corporation Limited ("MTRC") for us to provide valuation advice for various property interests of MTRC and the Kowloon-Canton Railway Corporation ("KCRC") for the purpose of incorporation in the Extraordinary General Meeting Circular to be issued in connection with the proposed merger of MTRC and KCRC (the "Circular"). We understand from the Company that these property interests constitute the property interests of the Enlarged Group. Unless the context otherwise requires, capitalised terms used in this report shall have the same meaning as ascribed to them in the Circular.

We confirm that we have carried out inspections, made relevant enquiries and obtained such further information as we consider necessary for the purpose of providing MTRC with our opinion of the value of the properties of the Enlarged Group as at 31 July 2007 ("the date of valuation").

### 1.2 Property Categorization

For the purpose of our valuation, the portfolio of the properties held by or to be held by MTRC and KCRC are categorized into the following groups:

Group 1 - Property interests held by MTRC for investment
Group 2 - Property interests held by MTRC for owner-occupation
Group 3 - Property interests held by MTRC for sale
Group 4 - Property interests held by MTRC for investment under construction
Group 5 - Property interests held by MTRC for development (packages awarded)
Group 6 - Property interests held by MTRC for development (packages to be awarded)
Group 7 - Other property interests of MTRC
Group 8 - Property interests held by KCRC for investment
Group 9 - Property interests held by KCRC for development (packages awarded)
Group 10 - Property interests held by KCRC for development (packages to be awarded)
Group 11 - Other property interests of KCRC

In the Circular, commercial accommodation/areas of Pierhead Garden, Sun Tuen Mun Centre and Hanford Garden, Plaza Ascot and the residential units and car parking spaces in Royal Ascot in Group 8 are classified as Category 1 Properties, whilst Citylink Plaza, KCRC Hung Hom Building and Trackside Villas in Group 8 are classified as Category 2 Properties. Properties in Group 9 hereof are classified as Category 3 Properties, whilst properties in Group 10 are classified as Category 4 Properties.

No meaningful valuation figures can be determined for the land and property used in connection with the operation and maintenance of the MTRC Railway and the KCRC Railway (the "Railway Property") (which, in the case of the KCRC Railway Property, we understand will be licensed to MTRC under the Service Concession). Any valuation figures that may be arrived at by applying normal valuation methodologies would be artificial, particularly given the legal restrictions on the Railway Property which include, amongst other things, provisions prohibiting the disposing of the relevant property or any interests therein and provisions prohibiting the certain use of relevant property for any purpose other than in connection with the operation of the MTRC Railway or KCRC Railway (as appropriate). The Railway Property has therefore not been valued for the purposes of this report.

MTRC and KCRC hold various properties from the Government of HKSAR and/or the Hong Kong Housing Authority under short term tenancies and licences for purposes of railway construction work sites, operation areas and radio base stations. Given their characteristics, nature of uses and the legal restrictions on use and assignment, these properties also have not been valued as no meaningful valuation figures can be determined.

### 1.3 Basis of Valuation and Valuation Methodologies

#### Group 1 and Group 8

Unless otherwise specified, our valuation of the property interests under Group 1 and Group 8, which are held for investment by MTRC and KCRC respectively, are made on the basis of the 'Market Value' adopted by The Hong Kong Institute of Surveyors ("HKIS"), set out as follows:

*"Market Value is the estimated amount for which a property should exchange on the Date of Valuation between a willing buyer and a willing seller in an arms-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion."*

In valuing the property interests under Group 1 and Group 8, we have adopted the income capitalization method and the direct comparison method. The income capitalization method is based on the capitalization of the current net income and reversionary income potential of the property interests by adopting appropriate capitalization rates, which are derived from analysis of sale transactions and our interpretation of prevailing investor requirements/expectations.

The direct comparison method is based on comparing the property to be valued directly with other comparable properties, which have transferred legal ownership around the date of valuation. Because of the heterogeneous nature of real estate properties, appropriate adjustments are usually required to allow for qualitative and quantitative differences that may affect the price likely to be achieved by the properties under consideration.

#### Group 2

Our valuation of the property interests under Group 2, which are held for owner-occupation by MTRC, are made on the Market Value basis. We have adopted the direct comparison method assuming sale of the properties in their existing state with the benefit of vacant possession.

#### Group 3

This group of property comprises mainly unsold units and car parking spaces within various completed residential developments. As instructed by MTRC, the unsold residential units and car parking spaces within each development are assessed as a single property interest and the market value definition has been applied to each of these interests. For the Commercial Development at Olympic Station, we have also assessed its market value as a single property interest.

We have adopted the direct comparison method assuming sale of the properties in their existing state with the benefit of vacant possession. For the commercial development and car parking spaces under this category, we have also adopted the income capitalization method in addition to the direct comparison method.

**Group 4**

This group comprises of a property held by MTRC for investment under construction. The property will be held by MTRC for investment purposes upon completion of its construction. The development parameters which have been adopted in our valuation are based upon the Government Land Grant documents, building plans approved by the Buildings Department and architectural plans provided by the MTRC. The valuation of the property has been made on the basis of market value of the portion of the property which is to be allocated to MTRC. The valuation methodology has been the income capitalization method and where appropriate the direct comparison method has been used to cross check the result. We have also allowed for the deduction of the outstanding fitting out costs (if any).

**Group 5 and Group 9**

For properties held by MTRC and KCRC for development, where development packages have been awarded, the development parameters which have been adopted in our valuation are based upon the Government Land Grant documents, the Master Layout Plans approved by the Town Planning Board as well as the building plans approved by the Buildings Department (if any).

For the properties in Group 5, the valuation of these properties has been prepared on the basis of either (i) the estimated market value of the portion of the relevant properties which is to be allocated to MTRC or (ii) the present value of any estimated surplus proceeds to be shared by MTRC as a result of disposal or leasing of the development properties in accordance with the terms within the respective development agreements between MTRC and the developers as advised to us.

For properties in Group 9, the valuation of these properties has been prepared on the basis of the present value of any estimated surplus proceeds to be shared by KCRC as a result of disposal or leasing of the development properties in accordance with the terms within the respective development agreements between KCRC and the developers as advised to us.

*Market Value of Portion of Properties to be Allocated to MTRC*

The market value of the portion of the relevant properties which is to be allocated to MTRC has been assessed by the deduction of the outstanding fitting out costs (if any).

In the course of our valuation, we have adopted the development programme, outstanding costs and other relevant information (if any) as advised by MTRC which are based upon the terms stipulated within the respective development agreements between MTRC and the developers.

*Present Value of Estimated Surplus Proceeds to be Shared by MTRC and KCRC*

The present value of any estimated surplus proceeds to be shared by MTRC and KCRC has been assessed by adopting the discounted cashflow (DCF) method. The DCF method takes into consideration year by year estimated net cash flows from the development project after deduction from the disposal proceeds for the development costs. The net cash flows are derived after having regard to our estimated growth rates of the disposal proceeds as well as construction costs, development phasing and other costs information provided by MTRC and KCRC. The net cash flows are discounted by an appropriate discount rate to derive a net present value. The discount rate is determined with reference to the indicative cost of capital of developers and risk premium associated with development projects.

In estimating the disposal proceeds to be derived from each project, we have based on 'Market Value' adopted by the HKIS. The principal valuation methodology has been the direct comparison method and where appropriate the income capitalization method has been used to cross check the results.

The development costs to be deducted include estimated/contracted construction costs (where appropriate), land premium, upfront payments (which include the costs for the project enabling works undertaken by MTRC or KCRC — such costs to be reimbursed by the developer under the respective development agreements between the developers and MTRC and KCRC, where appropriate), professional fees, contingencies (if appropriate), marketing costs and finance costs associated with the development. Information on the deductible costs (including upfront payment, construction costs, land premium) and profit sharing arrangements provided by MTRC are based on the terms stipulated within the executed land grants and respective agreements between the developers with either MTRC or KCRC.

**Group 6 and Group 10**

For properties held by MTRC and KCRC for development (save and except for Site C and Site D of Kowloon Southern Link), where development packages have not been awarded, the development parameters which have been adopted in our valuation are based upon the Land Grant or draft Land Grant documents prepared by the Government and the Master Layout Plans approved by the Town Planning Board. For Site C and Site D of Kowloon Southern Link of which draft Land Grant documents and approval of Master Layout Plans are not available, we have relied on the development parameters provided by MTRC with reference to the Transaction Agreements.

The valuation of these properties has been prepared on the basis of the present value of any estimated surplus proceeds which is expected to be shared by MTRC or KCRC as a result of disposal or leasing of the development properties through development agreements with developers.

The present value of any estimated surplus proceeds to be shared by MTRC and KCRC has been assessed by adopting the discounted cashflow (DCF) method.

In estimating the disposal proceeds to be derived from each project, we have based on 'Market Value' adopted by the HKIS. The principal valuation methodology has been the direct comparison method and where appropriate the income capitalization method has been used to cross check the results where appropriate.

The development costs to be deducted include estimated construction costs, estimated land premium, upfront payments (which include the costs for the project enabling works undertaken by MTRC or KCRC — such costs to be reimbursed by prospective developer(s) under the proposed development agreements between the developers with either MTRC and KCRC), professional fees, contingencies (if appropriate), marketing costs and finance costs associated with the development.

For the purpose of assessing the indicative land premium that is likely to be payable for the land grant made/to be approved by the Government in respect of the unawarded development properties, we have had regard to the prevailing Government land policy towards railway property development projects. In the course of the assessment of the indicative land premium, we have estimated such premium as to be the "market value" of the development site ignoring the presence of the new railway project i.e. the indicative market value as might be assessed by the Government with no account of benefits, if any, associated with the presence of the new railway. We have adopted the residual method (with regard to the latest Government practice) in estimating the land premium that might be payable and cross referenced with the comparable land sales and/or relevant land premium comparables, where available.

**Group 7 and Group 11**

In valuing the property interests under Group 7 and Group 11, we are of the opinion that these interests (save and except in respect of Ginza Mall) have no commercial value either because of the presence of non-alienation clauses within the leases or the lack of marketable and substantial profit rents.

### 1.4 Valuation Assumptions

We have valued each property interest independently and have ignored the potential effect of selling the entire portfolio at any one time. Unless otherwise specified, for property interest that comprises multiple floors or units, we have assessed the property as a single property interest.

Our valuations have been made on the assumption that the properties are sold on the open market without the benefit of a deferred terms contract, leaseback, joint venture, management agreement or any similar arrangement which could serve to affect the values of the properties.

No allowance has been made in our valuations for any charges, mortgages or amounts owing on the properties nor for any expenses or taxation which may be incurred in effecting sales. Unless otherwise stated, it is assumed that the properties are free from encumbrances, restrictions and outgoings of an onerous nature which could affect their values.

### 1.5 Additional Valuation Assumptions for the Property Interests Held by KCRC

Unless otherwise stated, we have assumed that all the interests in land granted to MTRC and KCRC can be freely transferable in the market and that any premium payable has already been fully paid.

For the three properties vested in KCRC including Citylink Plaza, KCRC Hung Hom Building and Trackside Villas, the interests, rights and liabilities of such properties are governed by the relevant vesting instruments including KCR Ordinance, a Memorandum of Agreement between the Government of the HKSAR and KCRC, a Consent Letter from the Lands Department (for Citylink Plaza), a Supplemental Agreement (for KCRC Hung Hom Building) and a Consent Letter from the Lands Department (for Trackside Villas). We have assumed that the construction and use of the properties have been in compliance with the vesting instruments and all relevant laws and regulations.

With reference to the Transaction Agreements, future Government Leases will be granted by the Government to KCRC at nil premium for Citylink Plaza and KCRC Hung Hom Building and that these properties could be freely assignable under the land grants. The relevant portions of Citylink Plaza and KCRC Hung Hom Building will be assigned by KCRC to MTRC. Valuation of these two properties are carried out on the assumption that they can be freely assigned in the market at nil premium.

Whereas for Trackside Villas, we have been advised that a Government Lease will be granted to MTRC for Trackside Villas subject to alienation restriction and user restriction as staff quarters. In the light of the alienation restriction and the user restriction, we are of the view that market value basis would not be appropriate in this instance. The property interest is assessed on the basis of "Investment Value" with reference to the guidance of the RICS Appraisal and Valuation Standards. Investment Value has been defined by the RICS as the value of property to a particular investor, including owner-occupier, for identified investment objectives. We have made use of DCF method, which takes into account the actual/forecasted rental incomes and costs, for the assessment of this property interest.

For the commercial accommodation/areas of Pierhead Garden, Sun Tuen Mun Centre and Hanford Garden, the assignment of these properties would be subject to written consent of the Registrar General (Land Officer) according to the land grants. The consents for assignment of the commercial accommodations of Pierhead Garden and Hanford Garden have been obtained and at nil premium and we have been advised that the consent for assignment of the commercial accommodation of Sun Tuen Mun Centre is being sought. We have valued the commercial accommodation of Sun Tuen Mun Centre on the assumption that consent to assign is available as at the date of valuation and at nil premium. We have made use of income capitalization approach for the assessment of these property interests and cross referenced with direct comparison method as appropriate.

### 1.6 Additional Valuation Assumptions for the Properties for Development

In the course of the estimation of the gross development value of the respective development properties, we have assumed that the development will be finished to a standard commensurate with newly completed comparable developments in the vicinity of the development concerned, with or without the benefit of the respective railway line, where appropriate.

We have assumed that the proposed uses are permissible under the relevant land grants, building regulations and other statutory requirements.

For the Government Lands included in the development schemes, it is assumed that the relevant land grants will be granted and payment of land premium will be allowed and the respective property interests can be freely assigned in the market. All consents, approvals and licences from the relevant Government departments for the properties have been granted/will be granted without any onerous conditions or undue time delay which may affect their values.

### 1.7 Title Investigation

We have been provided with copies of the some of the title documents relating to the properties and we also have caused searches to be made at the Land Registry for the property interests that are registered with the Land Registry. For the unsold units within various developments, random searches have been arranged for some of the units. However, we have not examined the original documents to verify ownership or to amendments thereto.

For the properties which are vested in the KCRC, we have made reference to the KCR Ordinance, copy of documents including Memorandum of Agreement between the Government of the HKSAR and KCRC, Consent Letter from the Lands Department (for Citylink Plaza), Supplemental Agreement (for KCRC Hung Hom Building) and Consent Letter from the Lands Department (for Trackside Villas) provided to us by MTRC.

For the property interests in The PRC, we have relied on the information provided by MTRC's PRC legal counsel regarding the title to the property interests.

### 1.8 Property Inspection

We have inspected the exterior and where possible the interior of the properties. We have not carried out a building survey, nor have we inspected those parts of the properties that are covered, unexposed or inaccessible and such parts have been assumed to be in good repair and condition. We cannot express an opinion about or advise upon the condition of uninspected parts and this report should not be taken as making any implied representation or statement about such parts. Neither can we express an opinion as to whether the properties are free from rot, infestation or any other structural defects. No tests have been carried out to any of the services within the properties.

We have not arranged for any investigation to be carried out to determine whether or not any deleterious or hazardous material has been used in the construction of the properties, or has since been incorporated, and we are therefore unable to report that the properties are free from risk in this respect. We have assumed that such investigation would not disclose the presence of any such material to any significant extent. We have also assumed that the properties have complied with relevant regulations and laws for construction and safety.

### 1.9 Site Investigation

We have not carried out site measurement to verify the correctness of the site areas of the properties and have assumed that the site areas shown on the documents and official site plans obtained are correct.

We were not instructed to carry out any investigations on site in order to determine the suitability of ground conditions and services etc. for future redevelopment, nor did we undertake archaeological, ecological or environmental surveys. Our valuations are on the basis that these aspects are satisfactory and that where developments are contemplated, no extraordinary expenses or delays will be incurred during the construction period due to these, or to archaeological or ecological matters. In the course of our valuations, we have assumed no contamination affecting the properties or the neighbouring land. However, should it be established subsequently that contamination exists at the properties or on any neighbouring land, or that the premises have been or are being put to any contaminative use, we reserve the right to adjust the values reported herein.

### 1.10 Source of Information

We have accepted the advice given to us by MTRC (including those information provided by KCRC through MTRC) on such matters as tenure, floor areas, particulars of occupancy and all other material information supplied. We have also relied on the information obtained from the Land Registry and the Buildings Department.

We have not verified independently the information made available to us. Our valuations are totally dependent on the adequacy and accuracy of the information available and/or the assumptions made.

We have not carried out on-site measurements of the properties at the time of inspection to verify the correctness of the floor areas and all dimensions, scaled measurements and areas quoted are approximate areas for reference only.

### 1.11 Plant and Machinery

Our valuation normally includes all plant and machinery that form part of the building services installations. However, process plant, machinery and equipment which may have been installed wholly in connection with the occupiers' commercial processes, together with furniture and furnishings, tenants' fixtures and fittings are excluded.

### 1.12 Limiting Conditions

Our valuation has been prepared in accordance with the "HKIS Valuation Standards on Properties" published by the HKIS and in compliance with Chapter 5 of the Listing Rules. Besides, our valuation services have been executed in accordance with our Quality Assurance System, accredited by HKQAA via ISO 9001:2000.

### 1.13 Independent Valuation

We have previously been instructed by MTRC to provide valuation advice in connection with some property interests within the subject property portfolios. We are not aware of any conflict of interest and/or potential conflict of interest as a result of such involvement. We confirm that we are an independent valuer for this valuation for the purpose of the HKIS Valuation Standards on Properties (First Edition as amended). We also confirm our independence for the purpose of Rule 5.08 of the Listing Rules.

### 1.14 Currency Exchange

The property interests in the PRC have been valued in Renminbi ("RMB") and such valuations have been translated into Hong Kong Dollars at the rate of exchange prevailing on the date of valuation at RMB0.97 to HK$1. There is no significant fluctuation in that exchange rate between the date of valuation and the date of this letter.

**1.15 Report**

Our summary of values and the valuation certificates of the property interests follow.

Yours faithfully,
For and on behalf of
**Jones Lang LaSalle Limited**
**Lau Chun Kong**
*MHKIS, MRICS, RPS(GP)*
*International Director*
*Licence No.: E-131615*

*Note: Mr. C K Lau is a registered professional surveyor and has over 20 years' experience in valuing properties in Hong Kong and has more than eight years experience in valuing properties in The PRC.*

## 2.0 SUMMARY OF VALUATIONS

### Group 1 — Property Interests Held by MTRC for Investment

| | Property | Market Value as at 31 July 2007 (HK$) | Interest Attributable to MTRC | Market Value Attributable to MTRC as at 31 July 2007 (HK$) |
|---|---|---|---|---|
| (1) | Interests of Telford Plaza II, Including Shopping Arcade and Various Car Parking Spaces, Telford Gardens, No. 33 Wai Yip Street, Kowloon Bay, Kowloon | $2,274,100,000 | 50% | $1,137,050,000 |
| (2) | Telford Plaza I including Shopping Arcade, Podium Shops, Recreation Facilities, Cinema, School and Market and Various Car Parking Spaces, Telford Gardens, No. 33 Wai Yip Street, Kowloon Bay, Kowloon | $7,135,000,000 | 100% | $7,135,000,000 |
| (3) | Luk Yeung Galleria including Shopping Arcade, Podium and Upper Podium Shops, Supermarket and Market Stalls and Various Car Parking Spaces in Luk Yeung Sun Chuen, Nos. 22-66 Wai Tsuen Road, Tsuen Wan, New Territories | $1,839,200,000 | 100% | $1,839,200,000 |
| (4) | Paradise Mall, Various Shops on the Podium, Market Stalls, Various Car Parking Spaces in the West Carpark Block, LP Gas Storage Compound and Recreational Areas, Heng Fa Chuen, No. 100 Shing Tai Road, Chai Wan, Hong Kong | $1,417,200,000 | 100% | $1,417,200,000 |

| | Property | Market Value as at 31 July 2007 *(HK$)* | Interest Attributable to MTRC | Market Value Attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (5) | Ground Floor Unit, No. 308 Nathan Road, Yau Ma Tei, Kowloon | $32,000,000 | 100% | $32,000,000 |
| (6) | Ground Floor Unit, No. 783 Nathan Road, Mong Kok, Kowloon | $9,700,000 | 100% | $9,700,000 |
| (7) | Kindergarten on Podium Level and Car Park Nos. 1-126, New Kwai Fong Gardens, Nos. 12-20 Kwai Yi Road, Kwai Chung, New Territories | $41,000,000 | 100% | $41,000,000 |
| (8) | Various Private Car Parking Spaces on Car Park Floors P1, P2 and P3 at Section B, Phase 1 Car Parking Spaces, Kornhill, No. 10 Hong Yue Street, Quarry Bay, Hong Kong | $87,000,000 | 100% | $87,000,000 |
| (9) | Interests of Shop Nos. 44, 85, 86, 87, 88, 89, 90, 91, 92 and 93 on the First Floor of the Commercial Complex, Admiralty Centre, No. 18 Harcourt Road, Admiralty, Hong Kong | $56,000,000 | 50% | $28,000,000 |
| (10) | Roof of Tower 1, Admiralty Centre, No. 18 Harcourt Road, Admiralty, Hong Kong | $22,000,000 | 100% | $22,000,000 |
| (11) | Commercial Development, Kindergarten and Commercial Carpark, Tierra Verde (The commercial development is currently known as "Maritime Square"), No. 33 Tsing King Road, Tsing Yi, New Territories | $4,391,200,000 | 100% | $4,391,200,000 |

| | Property | Market Value as at 31 July 2007 *(HK$)* | Interest Attributable to MTRC | Market Value Attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (12) | Interests of Various Private Car Parking Spaces, One International Finance Centre, No. 1 Harbour View Street and 33rd to 52nd Floors (excluding Suites 3301 to 3305 on 33rd Floor and 34th and 44th Floors omitted) and Interests of 1,172 Private Car Parking Spaces in Basement 3, Basement 4 and Basement 5, Two International Finance Centre, No. 8 Finance Street, Central, Hong Kong | $9,473,000,000 | 51% for car parking spaces and 100% for offices | $9,037,000,000 |
| (13) | Indoor Sports Hall at Island Harbourview, No. 11 Hoi Fai Road, Kowloon | $23,000,000 | 100% | $23,000,000 |
| (14) | Portion of Market, Olympian City II, No. 18 Hoi Ting Road, Kowloon | $80,000,000 | 100% | $80,000,000 |
| (15) | Wet Market, Caribbean Bazaar, No. 1 Kin Tung Road, Caribbean Coast, Tung Chung, Lantau Island, New Territories | $16,000,000 | 100% | $16,000,000 |
| (16) | The Lane and 16 Car Parking Spaces and 1 Motor Cycle Parking Space at Residence Oasis, No. 15 Pui Shing Road, Tseung Kwan O, New Territories | $459,100,000 | 100% | $459,100,000 |
| (17) | Interest of Carpark Development (comprising 450 Public Car Parking Spaces, 46 Ancillary Residential Car Parking Spaces, 8 Ancillary Commercial Car Parking Spaces and 10 Motor Cycle Parking Spaces), Choi Hung Park & Ride, No. 8 Clear Water Bay Road, Kowloon | $98,000,000 | 51% | $49,980,000 |

| | Property | Market Value as at 31 July 2007 *(HK$)* | Interest Attributable to MTRC | Market Value Attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (18) | Interest of the Edge and 50 Car Parking Spaces at Grandiose, No. 9 Tong Chun Street, Tseung Kwan O, New Territories | $728,000,000 | 70% | $509,600,000 |
| | | | **Sub-total** | **$26,314,030,000** |

**Group 2 — Property Interests Held by MTRC for Owner-occupation**

| | Property | Market Value as at 31 July 2007 *(HK$)* | Interest Attributable to MTRC | Market Value Attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (19) | Suites 3301 to 3305 on 33rd Floor, Two International Finance Centre, International Finance Centre, No. 8 Finance Street, Central Hong Kong | $172,000,000 | 100% | $172,000,000 |
| (20) | Office No. 2101 on 21st Floor, Worldwide House, No. 19 Des Voeux Road Central, Hong Kong | $32,500,000 | 100% | $32,500,000 |
| (21) | MTR Tower and 52 Car Parking Spaces at Telford Plaza, No. 33 Wai Yip Street, Kowloon Bay, Kowloon | $1,508,000,000 | 100% | $1,508,000,000 |
| (22) | Levels L2, Mezzanine Floor, L8 to L10 and L23 of Hang Seng Tower, Telford Plaza, No. 33 Wai Yip Street, Kowloon Bay, Kowloon | $417,000,000 | 100% | $417,000,000 |
| | | | **Sub-total** | **$2,129,500,000** |

**Group 3 — Property Interests Held by MTRC for Sale**

| | **Property** | **Market Value of the Property Interest Attributable to MTRC as at 31 July 2007** *(HK$)* |
|---|---|---|
| (23) | Commercial Development and 579 Residential Car Parking Spaces, 117 Office Car Parking Spaces and 330 Commercial Car Parking Spaces at Olympian City One and Island Harbourview and Various Unsold Flats at Island Harbourview Olympic Station, No. 11 Hoi Fai Road, and Kindergarten and Various Unsold Flats and Car Parking Spaces at Harbour Green, No. 8 Sham Mong Road, Kowloon | $613,300,000 |
| (24) | Various Unsold Residential Units, Car Parking Spaces and Motor Cycle Parking Spaces at<br>• The Grandiose, No. 9 Tong Chun Street, Tseung Kwan O, New Territories<br>• Central Heights, No. 9 Tong Tak Street, Tseung Kwan O, New Territories | $83,900,000 |
| (25) | Various Unsold Residential Units and Car Parking Spaces at The Arch, No. 1 Austin Road West, Kowloon | |
| (26) | Various Car Parking Spaces and Motor Cycle Parking Spaces at Residence Oasis, No. 15 Pui Shing Road, Tseung Kwan O, New Territories | |
| (27) | Various Unsold Residential Units, Car Parking Spaces and Motor Cycle Parking Spaces at Metro Town, No. 8 King Ling Road, Tseung Kwan O, New Territories | |

| | Property | Market Value of the Property Interest Attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|
| (28) | Various Unsold Residential Units and Car Parking Spaces at Caribbean Coast, Tung Chung, New Territories | |
| | Total for Property (25) to Property (28): | $998,600,000 |
| | **Sub-total** | **$1,695,800,000** |

**Group 4 — Property Interests Held by MTRC for Investment Under Construction**

| | Property | Market Value of the Property Interest Attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|
| (29) | The Interest in Retail Accommodation and Kindergarten (Site E), Cross Border Coach Terminus (Site C) and 898 Car Parking Spaces, Kowloon Station, No. 1 Austin Road West, Kowloon | $ 6,621,000,000 |
| | **Sub-total** | **$6,621,000,000** |

**Group 5 — Property Interests Held by MTRC for Development (Packages Awarded)**

| | Property | Market Value of the Property Interest Attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|
| (30) | Coastal Skyline and Caribbean Coast (Excluding the Whole of Towers 6, 7, 16 and Portion of Tower 15 and 285 Car Parking Spaces) Tung Chung, Lantau Island, New Territories | $ 137,000,000 |
| (31) | Packages One and Two, Tseung Kwan O Area 86 Tseung Kwan O, New Territories | $4,788,000,000 |

| **Property** | | **Market Value of the Property Interest Attributable to MTRC as at 31 July 2007** *(HK$)* |
|---|---|---|
| (32) The Interest in The Harbourside (Site D), Kowloon Station, No. 1 Austin Road West, Kowloon | | |
| (33) Tiu Keng Leng, Phase 2, Tseung Kwan O, New Territories | | |
| (34) Tseung Kwan O Area 56, Tseung Kwan O Station, Tseung Kwan O, New Territories | | |
| | Total for Property (32) to Property (34): | $ 6,527,000,000 |
| | **Sub-total** | **$11,452,000,000** |

**Group 6 — Property Interests Held by MTRC for Development (Packages to be Awarded)**

| **Property** | | **Market Value of the Property Interest Attributable to MTRC as at 31 July 2007** *(HK$)* |
|---|---|---|
| (35) Packages Three to Thirteen (maximum) Tseung Kwan O Area 86, Tseung Kwan O, New Territories | | |
| (36) Tsing Yi Lorry Park, No. 31 Tsing King Road, Tsing Yi, New Territories | | |
| | **Sub-total** | **$5,423,000,000** |

**Group 7 — Other Property Interests of MTRC**

| | Property | Market Value Attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|
| (37) | 2 Leased Office Premises in the United Kingdom and 8 Leased Office Premises in The PRC | No commercial value |
| (38) | Interest in Ginza Mall, No.48 Dongzhimenwai Main Street, Beijing, The PRC | $84,000,000 |
| | **Sub-total:** | **$84,000,000** |
| | **GRAND TOTAL FOR GROUP 1 TO GROUP 7:** | **HK$53,719,330,000** |

**Group 8 — Property Interests Held by KCRC for Investment**

| | Property | Market Value as at 31 July 2007 *(HK$)* | Interest Attributable to KCRC | Market Value Attributable to KCRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (39) | Commercial Accommodation, Kindergarten, 20 Residential Units and 20 Car Parking Spaces, Royal Ascot, No. 1 Tsun King Road, Shatin, New Territories | $532,000,000 | 100% | $532,000,000 |
| (40) | Commercial Accommodation (including the Reserved Commercial Areas) and Car Parking Space Nos. 1-10, 41-62 on Lower Part of the 1st Floor, Pierhead Garden, Nos. 168-236 Wu Chui Road, Tuen Mun, New Territories | $752,000,000 | 100% | $752,000,000 |
| (41) | Commercial Accommodation (Comprising the Reserved Commercial Areas and the Kindergarten) and Portions of the Parking Areas, Sun Tuen Mun Centre, Nos. 55-65 Lung Mun Road, Tuen Mun, New Territories | $259,000,000 | 100% | $259,000,000 |

| | Property | Market Value as at 31 July 2007 *(HK$)* | Interest Attributable to KCRC | Market Value Attributable to KCRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (42) | Reserved Commercial Areas and Car Parking Space Nos. G1-G19 on Ground Floor and P98-P100 on Lower Podium Level, Hanford Garden, No. 333 Castle Peak Road, Tuen Mun, New Territories | $130,000,000 | 100% | $130,000,000 |
| (43) | Retail Floor, 1st to 6th Floors, Citylink Plaza, No. 1 Sha Tin Station Circuit, Sha Tin, New Territories, Hong Kong | $1,552,000,000 | 100% | $1,552,000,000 |
| (44) | Portion of Ground Floor and Portion of 1st Floor of KCRC Hung Hom Building, No. 8 Cheong Wan Road, Hung Hom, Kowloon | $60,000,000 | 100% | $60,000,000 |
| (45) | Staff Quarters, Trackside Villas, No. 4105 Tai Po Road, Tai Po, New Territories | $69,000,000 | 100% | $69,000,000** |
| | **Sub-Total** | | | **$3,354,000,000** |

*Notes:*

(i) Property (39) is currently held under private treaty grants. The lessee has the right to freely assign the interest in land under the land grant.

(ii) According to the land grants, the assignment of Properties (40) to (42) are subject to written consent of the Registrar General (Land Officer). We have valued these properties on the assumption that such consents are available as at the date of valuation and at nil premium.

(iii) The valuation of Properties (43) and (44) is made on the assumption that Government Leases will be granted and the lessee has the right to freely assign the interest in land without a premium.

(iv) ** Property (45) is subject to restrictions against alienation and user restriction as staff quarters. Our assessment is on the basis of Investment Value which does not represent the market value of the property.

**Group 9 — Property Interests Held by KCRC for Development (Packages Awarded)**

| | Property | Market Value of the Property Interest Attributable to KCRC as at 31 July 2007 *(HK$)* |
|---|---|---|
| (46) | East Rail — Ho Tung Lau (Site A)<br>Sha Tin,<br>New Territories<br>Sha Tin Town Lot No. 470 | |
| (47) | Ma On Shan Rail — Wu Kai Sha<br>Sha Tin,<br>New Territories<br>Sha Tin Town Lot No. 530 | |
| (48) | Ma On Shan Rail —<br>Tai Wai Maintenance Centre<br>Sha Tin,<br>New Territories<br>Sha Tin Town Lot No. 529 | |
| | **Sub-total** | **$5,166,000,000** |

**Group 10 — Property Interests Held by KCRC for Development (Packages to be Awarded)**

| | Property | Market Value of the Property Interest Attributable to KCRC as at 31 July 2007 *(HK$)* |
|---|---|---|
| (49) | Ma On Shan Rail —<br>Che Kung Temple<br>Sha Tin,<br>New Territories | |
| (50) | Ma On Shan Rail —<br>Tai Wai Station<br>Sha Tin,<br>New Territories | |
| (51) | Light Rail —<br>Tin Shiu Wai Terminus<br>Yuen Long,<br>New Territories | |

| | Property | Market Value of the Property Interest Attributable to KCRC as at 31 July 2007 *(HK$)* |
|---|---|---|
| (52) | Kowloon Southern Link — Sites C and D Tsimshatsui, Kowloon | |
| | **Sub-total** | **$2,054,000,000** |

**Group 11 — Other Property Interests of KCRC**

| | Property | Market Value Attributable to KCRC as at 31 July 2007 *(HK$)* |
|---|---|---|
| (53) | 2 Leased Properties in Hong Kong and 2 Leased Premises in the PRC | No commercial value |
| | **Sub-total** | **No commercial value** |
| | **GRAND TOTAL FOR GROUP 8 TO GROUP 11:** | **HK$10,574,000,000** |

## 3.0 VALUATION CERTIFICATES

### Group 1 — Property Interests Held by MTRC for Investment

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (1) | 50% Interests of Telford Plaza II, including Shopping Arcade and Various Car Parking Spaces, Telford Gardens, No. 33 Wai Yip Street, Kowloon Bay, Kowloon<br><br>Portion of New Kowloon Inland Lot No. 6201 and New Kowloon Inland Lot No. 5744 | Telford Plaza II comprises a 4-level retail podium over a transport interchange, a 3-level carpark and the Kowloon Bay Depot. The development was built in 1996.<br><br>The subject property comprises 4 levels of retail accommodation and 136 car parking spaces in the commercial development. The total lettable area of the property is approximately 208,939ft$^2$ (19,410.9m$^2$).<br><br>New Kowloon Inland Lot No. 6201 is held from the Government under Conditions of Exchange No. 12289 from 12 January 1994 until 30 June 2047 and New Kowloon Inland Lot No. 5744 is held from the Government under Conditions of Grant No. 11083 for a term of 99 years from 1 July 1898 which has been extended to expire on 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The retail podium is let on full internal repairing leases and is fully occupied.<br><br>The majority of the lease terms are for three years.<br><br>The total revenue receivable for the retail portion for the month of June 2007 was approximately HK$11,135,000.<br><br>The car parking spaces are currently licensed on monthly and hourly basis.<br><br>The total revenue receivable for the car parking spaces for the month of June 2007 was approximately HK$357,000. | HK$1,137,050,000<br><br>(Interests attributable to MTRC) |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (2) | Telford Plaza I including Shopping Arcade, Podium Shops, Recreational Facilities, Cinema, School and Market and Various Car Parking Spaces, Telford Gardens, No. 33 Wai Yip Street, Kowloon Bay, Kowloon<br><br>Portion of New Kowloon Inland Lot No. 5744 | Telford Plaza I comprises a 3-level retail podium over the Kowloon Bay Depot. The development was built in 1980.<br><br>The subject property comprises 3 levels of shopping arcade including podium shops, recreational facilities, a cinema, a school, a kindergarten, a market and 993 private car parking spaces. The total lettable area of the property as provided is approximately 426,545ft$^2$ (39,627.0m$^2$).<br><br>New Kowloon Inland Lot No. 5744 is held from the Government under Conditions of Grant No. 11083 for a term of 99 years from 1 July 1898 which has been extended to expire on 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The retail podium is let on full internal repairing leases and approximately 99.8% of the floor space is occupied.<br><br>The majority of the lease terms are for three years.<br><br>The total revenue receivable for the retail portion for the month of June 2007 was approximately HK$33,061,000.<br><br>The car parking spaces are currently licensed on monthly and hourly basis.<br><br>The total revenue receivable for the car parking spaces for the month of June 2007 was approximately HK$1,542,000. | HK$7,135,000,000 |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) The cinema forming part of the property was under alteration works as at the date of valuation. In the course of our valuation, we have taken into account the alteration works which have been / are to be carried out at the cinema.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (3) | Luk Yeung Galleria including Shopping Arcade, Podium and Upper Podium Shops, Supermarket and Market Stalls and Various Car Parking Spaces in Luk Yeung Sun Chuen, Nos. 22-66 Wai Tsuen Road, Tsuen Wan, New Territories<br><br>Portion of Tsuen Wan Town Lot No. 256 | The property comprises various shop units, a kindergarten, supermarket and market stalls within a 3-storey commercial podium, together with 651 car parking spaces within the development erected over the Tsuen Wan Station. The property was built in 1983.<br><br>As provided, the total lettable area of the property before renovation of the upper podium is approximately 129,281ft$^2$ (12,010.5m$^2$).<br><br>Tsuen Wan Town Lot No. 256 is held from the Government under New Grant No. 5955 for a term of 99 years from 1 July 1898 which has been extended to expire on 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The commercial space is let on full internal repairing leases and currently 71.5% of the total space is occupied.<br><br>The majority of the lease terms are for three years.<br><br>The total revenue receivable for the commercial space and market stalls for the month of June 2007 was approximately HK$7,704,000.<br><br>The car parking spaces are currently licensed on monthly and hourly basis.<br><br>The total revenue receivable for the car parking spaces for the month of June 2007 was approximately HK$950,000. | HK$1,839,200,000 |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) Portion of the upper podium and 2nd Floor was under renovation at the date of valuation. In the course of our valuation, we have taken into account the enhancement works which have been/are to be carried out.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (4) | Paradise Mall, Various Shops on the Podium, Market Stalls, Various Car Parking Spaces in the West Carpark Block, LP Gas Storage Compound and Recreational Areas, Heng Fa Chuen, No. 100 Shing Tai Road, Chai Wan, Hong Kong<br><br>Portion of The Remaining Portion of Chai Wan Inland Lot No. 121 | The property comprises a 3-level shopping arcade, a clinic and a market at road level, 3 kindergartens, 415 private car parking spaces on the first to third floors of a 4-storey commercial/car parking podium, a LP Gas Storage Compound, a 2-storey recreation building and associated recreational facilities provided on a commercial/car parking podium within a residential development. The development was built in 1989.<br><br>The recreational facilities include a swimming pool, gymnasium, restaurant, badminton courts, function rooms, squash court, tennis courts, golf driving range and sauna room. The facilities were developed in various stages since 1986.<br><br>The approximate lettable areas of the shopping arcade, shops and market stalls as provided are listed as follows: | The shopping arcade is let on full internal repairing leases and is approximately 98.6% occupied.<br><br>The majority of the lease terms are for three years.<br><br>The total revenue receivable for the shopping arcade and market stalls for the month of June 2007 was approximately HK$8,099,000.<br><br>The car parking spaces are currently licensed on monthly and hourly basis.<br><br>The total revenue receivable for the car parking spaces for the month of June 2007 was approximately HK$580,000.<br><br>The LP Gas Storage Compound is granted to Shell Development (HK) Limited under an Extension Agreement for supply of liquefied petroleum gas on rent free basis with exclusive use for an extended term of 3 years from 13 March 2005.<br><br>The recreation areas are operated under the name of "Heng Fa Chuen Club" and is used exclusively by the residents of Heng Fa Chuen and their bona fide guests only.<br><br>The total revenue for the recreational club for the month of June 2007 was approximately HK$710,000. | HK$1,417,200,000 |

| | Approximate Lettable Area | |
|---|---|---|
| | *($ft^2$)* | *($m^2$)* |
| Shopping arcade | 172,942 | 16,067 |
| Clinic on G/F | 2,236 | 208 |
| 3 Kindergartens | 26,881 | 2,497 |
| Market stalls on G/F | 13,084 | 1,215 |
| Total | 215,143 | 19,987 |

The covered area of the LP Gas Storage Compound and the recreation building is approximately 1,870ft$^2$ (173.73m$^2$) and 22,303ft$^2$ (2,072.00m$^2$) respectively.

Chai Wan Inland Lot No. 121 is held from the Government under Conditions of Grant No. 11789 for a term of 75 years from 3 April 1985 renewable for a further term of 75 years. The Government rent payable for the entire lot is HK$1,000 per annum.

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (5) | Ground Floor Unit, No. 308 Nathan Road, Yau Ma Tei, Kowloon<br><br>Portion of Kowloon Inland Lot No. 10620 | The property comprises a single-storey shop unit situated immediately adjacent to a vent shaft of Jordan Station. The property was built in 1976.<br><br>As provided, the lettable area of the property is approximately 753ft$^2$ (69.96m$^2$)<br><br>The registered site area of the whole lot is approximately 1,851ft$^2$ (172.00m$^2$)<br><br>Kowloon Inland Lot No. 10620 is held from the Government under Conditions of Grant No. 11423 for a term of 75 years from 14 September 1914 renewed for a further term of 75 years. The Government rent payable for the entire lot is HK$28,800 per annum. | The property is currently let for a term of three years from 8 December 2004 to 7 December 2007, at a monthly basic rent of HK$120,000 or a turnover rent based on the monthly gross turnover in each month of the said term whichever shall be the higher, exclusive of rates and management fee. | HK$32,000,000 |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (6) | Ground Floor Unit, No. 783 Nathan Road, Mong Kok, Kowloon<br><br>Portion of Kowloon Inland Lot No. 10634 | The property comprises a single-storey shop unit situated immediately adjacent to a vent shaft of Prince Edward Station, completed in 1979.<br><br>As provided, the lettable area of the property is approximately 392ft$^2$ (36.42m$^2$)<br><br>The registered site area of the whole lot is approximately 1,701ft$^2$ (158.00m$^2$)<br><br>Kowloon Inland Lot No. 10634 is held from the Government under Conditions of Grant No. 11428 for a term of 75 years from the 2 February 1931 renewed for a further term of 75 years. The Government rent payable for the entire lot is HK$29,880 per annum. | The property is currently let for a term of three years from 16 May 2006 to 15 May 2009. The existing rent as at the date of valuation is HK$41,160, or a turnover rent based on the monthly gross turnover, whichever shall be the higher, exclusive of rates and management fee. | HK$9,700,000 |

*Note:*

(1) The registered owner of the property is MTRC.

**Group 1 — Property Interests Held by MTRC for Investment**

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (7) | Kindergarten on Podium Level and Car Park Nos. 1-126, New Kwai Fong Gardens, Nos. 12-20 Kwai Yi Road, Kwai Chung, New Territories<br><br>232/20,410th equal and undivided shares of and in Kwai Chung Town Lot No. 375 | The property comprises a kindergarten on the Podium Level and 126 car parking spaces on the Mezzanine Floor of a 3-storey car parking / commercial podium within a residential development. The development was built in 1983.<br><br>As provided, the net area of the kindergarten is approximately 5,813ft$^2$ (540.05m$^2$).<br><br>Kwai Chung Town Lot No. 375 is held from the Government under New Grant No. 5975 for a term of 99 years from 1 July 1898 which has been extended to expire on 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The kindergarten is currently let for a term of three years from 1 August 2004 to 31 July 2007 at a current monthly rent of HK$58,130, exclusive of rates and management fee.<br><br>The car parking spaces are currently licensed on monthly and hourly basis.<br><br>The total revenue receivable for the car parking spaces for the month of June 2007 was approximately HK$162,000. | HK$41,000,000 |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (8) | Various Private Car Parking Spaces on Car Park Floors P1, P2 and P3 at Section B, Phase 1 Car Parking Spaces, Kornhill, No. 10 Hong Yue Street, Quarry Bay, Hong Kong<br><br>292/700,000th equal and undivided share of and in The Remaining Portion of Inland Lot No. 8566 | The property comprises altogether 292 private car parking spaces on Car Park Floors P1, P2 and P3 of a commercial podium provided with car parks, recreational facilities and kindergarten within the Kornhill development. The development was built in 1986.<br><br>Inland Lot No. 8566 is held from the Government under Conditions of Exchange No. 11728 for a term of 75 years from 27 April 1984 renewable for a further term of 75 years. The Government rent payable for the entire lot is HK$1,000 per annum. | The property is currently licensed on monthly and hourly basis.<br><br>The total revenue received for the property for the month of June 2007 was approximately HK$520,000. | HK$87,000,000 |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (9) | 50% Interests of Shop Nos. 44, 85, 86, 87, 88, 89, 90, 91, 92 and 93 on the First Floor of the Commercial Complex, Admiralty Centre, No. 18 Harcourt Road, Admiralty, Hong Kong<br><br>263/227,600th equal and undivided share of and in Inland Lot No. 8423 | The property comprises 10 shop units on the first floor of a 4-storey commercial podium in Admiralty Centre, erected above the Admiralty Station. The development was built in 1980.<br><br>As provided, the aggregate lettable area of the 10 shop units is approximately 3,080 $ft^2$ (286.14 $m^2$).<br><br>Inland Lot No. 8423 is held from the Government under Conditions of Grant No. 11226 for a term of 75 years from 18 August 1978 renewable for a further term of 75 years. The Government rent payable for the entire lot is HK$1,000 per annum. | The 10 shop units are currently let for a term of three years from 1 January 2005 up to 31 December 2007, at a base monthly rent of HK$283,619 or at a turnover rent based on the monthly gross turnover in each month of the said term, whichever is the higher, exclusive of rates and management fees. | HK$28,000,000<br><br>(Interests attributable to MTRC) |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (10) | Roof of Tower 1, Admiralty Centre, No. 18 Harcourt Road, Admiralty, Hong Kong<br><br>22/227,600th equal and undivided shares of and in Inland Lot No. 8423 | The property comprises a Neon Light Sign on the roof of a 29-storey office building erected over a 4-storey commercial podium. The building was built in 1980.<br><br>As provided, the property has a dimension of 40 meters (length) by 6 meters (height), with a display area of approximately 2,583ft$^2$ (240.00m$^2$)<br><br>Inland Lot No. 8423 is held from the Government under Conditions of Grant No. 11226 for a term of 75 years from 18 August 1978 renewable for a further term of 75 years. The Government rent payable for the entire lot is HK$1,000 per annum. | The property is licensed for a fixed term of two years from 1 October 2006 to 30 September 2008. The current licence fee is HK$299,000 per month, exclusive of Government rates, Government licence and electricity charges for the lighting of the advertising space. | HK$22,000,000 |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) We noted that the Agent is entitled to terminate the Licence Agreement at any time during the term by serving a prior written notice of one month upon MTRC that the Sign (as viewed from seaside promenade of Inter-Continental Hotel) is blocked completed or partially by any building and/or structural and/or temporary construction devices, whether connected to the Site or another structure. The site in front of the property was reserved for the construction of the proposed Headquarters of the Hong Kong Special Administrative Region Government.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (11) | Commercial Development, Kindergarten and Commercial Carpark, Tierra Verde (The commercial development is currently known as "Maritime Square"), No. 33 Tsing King Road, Tsing Yi, New Territories<br><br>91,429/935,384th equal and undivided share of and in Tsing Yi Town Lot No. 132 | The property comprises 4-levels of commercial space, a kindergarten on the ground floor, 109 car parking spaces and 50 motor cycle parking spaces on the ground floor and 111 car parking spaces on the mezzanine floor of a 6-storey retail/car parking podium within a residential development. The development was built in 1998.<br><br>The total lettable areas of the commercial spaces and the kindergarten are approximately 311,413ft$^2$ (28,931.0m$^2$) and 9,903ft$^2$ (920.0m$^2$) respectively.<br><br>Tsing Yi Town Lot No. 132 is held from the Government under Conditions of Grant No. 6993 from 7 March 1996 until 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The commercial space is let on full internal repairing leases and is currently fully let.<br><br>The majority of the lease terms are for three years.<br><br>The total revenue for the commercial space for the month of June 2007 was approximately HK$23,117,000.<br><br>The kindergarten is currently let on full internal repairing lease for a term of three years from 1 July 2005 to 30 June 2008 at a monthly rent of HK$128,739. The rent is exclusive of rates and management fee.<br><br>The car parking spaces are currently licensed on hourly basis.<br><br>The total revenue for the car parking spaces for the month of June 2007 was approximately HK$449,000. | HK$4,391,200,000 |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (12) | 51% Interests of Various Private Car Parking Spaces, One International Finance Centre, No. 1 Harbour View Street and 100% Interests of 33rd to 52nd Floors (excluding Suites 3301 to 3305 on 33rd Floor and 34th and 44th Floors omitted) and 51% Interests of 1,172 Private Car Parking Spaces in Basement 3, Basement 4 and Basement 5, Two International Finance Centre, No. 8 Finance Street, Central, Hong Kong<br><br>Portion of Site A and Portion of Site R of Inland Lot No. 8898 | The property comprises 136 private car parking spaces on Basement Levels 3 and 4 of a multi-storey commercial podium within One International Finance Centre development ("Property A"). The development was built in 1998.<br><br>The property also comprises seventeen office floors from the 35th to 52nd Floors (34th and 44th floors omitted), part of the 33rd Floor and 1,172 private car parking spaces at Basement 3 to Basement 5 in Two International Finance Centre on the Northern Site in Site R of Inland Lot No. 8898 ("Property B").<br><br>According to the information provided, the total lettable area of Property B is approximately 425,492ft$^2$ (39,529.2m$^2$). The subject portion of Property B was completed in 2003.<br><br>Inland Lot No. 8898 is held from the Government under Conditions of Grant No. 12459 from 21 May 1997 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The office space of Property B has been fully tenanted or committed for tenancies as at the date of valuation.<br><br>Approximately 88% of the occupied space has been leased for terms of more than five years.<br><br>The car parking spaces are currently let on monthly and hourly basis.<br><br>The total revenue for the car parking spaces from Property A and Property B for the month of June 2007 was approximately HK$20,254,000. | HK$9,037,000,000<br><br>(Interests attributable to MTRC) |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (13) | Indoor Sports Hall at Island Harbourview, No. 11 Hoi Fai Road, Kowloon<br><br>150,708/3,980,030th equal and undivided share of and in Kowloon Inland Lot No. 11074 | The property comprises an Indoor Sports Hall on the 2nd and 3rd floors and roof top of a multi-storey commercial podium provided with shopping arcades, car park, social welfare and recreational facilities within a comprehensive residential and commercial development. The development was built in 1999.<br><br>As provided, the total gross floor area of the property is approximately 142,295ft$^2$ (13,219.485m$^2$), including 38,722ft$^2$ (3,597.397m$^2$) indoor area, 94,411ft$^2$ (8,770.957m$^2$) outdoor area and 9,162ft$^2$ (851.131m$^2$) mechanical rooms area.<br><br>Kowloon Inland Lot No. 11074 is held from the Government under Conditions of Grant No. 12375 from 31 January 1996 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The property is operated under the name of "Waterfall Golf-Gym Sports World" subject to an Operation Agreement for a fixed term of three years from 1 April 2005 to 31 March 2008 at a monthly rate of HK$120,000 or at a turnover rent based on the gross sales turnover in each month of the said term, whichever is higher.<br><br>The operator is responsible for all Government rates, management expenses, other outgoings and utility expenses. | HK$23,000,000 |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (14) | Portion of Market, Olympian City II, No. 18 Hoi Ting Road, Kowloon<br><br>Portion of Kowloon Inland Lot No. 11090 | The property comprises Portion of Market located within a combined shop unit on the Ground Floor of a multi-storey commercial podium provided with shopping arcade and car park within a comprehensive residential and commercial development. The commercial podium was built in 2001.<br><br>As provided, the total lettable area of the property is approximately 13,472ft$^2$ (1,251.58m$^2$).<br><br>Kowloon Inland Lot No. 11090 is held from the Government under Conditions of Grant No. 12434 from 10 January 1997 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The property is currently let as part of a supermarket for a term of six years from 1 October 2001 to 30 September 2007. The monthly rent of the property as at the date of valuation is HK$484,992 or at a turnover rent based on the gross turnover of the month, whichever is higher, exclusive of rates, management fees and other outgoings. | HK$80,000,000 |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (15) | Wet Market, Caribbean Bazaar, No. 1 Kin Tung Road, Caribbean Coast, Tung Chung, Lantau Island, New Territories<br><br>508/428,830th equal and undivided share of and in Tung Chung Town Lot No. 5 | The property comprises a portion of a combined shop unit on Podium First Floor of the communal podium provided with shopping arcade and basement car park within the Caribbean Coast development.<br><br>The property was built in 2004.<br><br>As provided, the gross floor area of the property is approximately 5,465ft$^2$ (507.71m$^2$).<br><br>Tung Chung Town Lot No. 5 is held from the Government under New Grant No. 8102 from 26 June 1997 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The property is currently let for a term of six years from 1 February 2006 to 31 January 2012. The current monthly basic rent as at the date of valuation is HK$120,472.<br><br>A turnover rent would be topped up onto the basic rent if the agreed percentage of monthly gross sales turnover exceeds an agreed aggregate sum of the monthly basic rent of the property and its adjoining premises i.e. Shop 22 on Podium First Floor of Caribbean Coast.<br><br>The above rent is exclusive of rates and management fees. | HK$16,000,000 |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) A temporary waiver is approved by the Lands Department dated 21 February 2006 as registered in the Land Registry vide Memorial No. 06032901870139 which permits the operation of the Wet Market in the form of supermarket for three years commencing on 16 February 2006 and expiring on 15 February 2009 and thereafter quarterly at an annual waiver fee of HK$158,400.

(3) It is stipulated in the lease that any waiver fee(s) and/or Government Charges payable for the temporary waiver shall be borne and paid by the tenant solely on a reimbursement basis.

(4) We have taken into account of the benefits of the said waiver in the course of our valuation.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (16) | The Lane and 16 Car Parking Spaces and 1 Motor Cycle Parking Space at Residence Oasis, No. 15 Pui Shing Road, Tseung Kwan O, New Territories<br><br>7,710/490,110th equal and undivided shares of and in Tseung Kwan O Town Lot No. 24 | The property comprises one level of commercial space, 16 car parking spaces and 1 motor cycle parking space within a 7-storey retail/car parking/clubhouse podium of the residential development.<br><br>The property has a single storey of retail accommodation including arcade shops and restaurants. The total lettable area is approximately 28,303ft$^2$ (2,629.41m$^2$).<br><br>The car parking spaces of the property are located on Level 1 of the three basement carparking levels.<br><br>Two Occupation Permits dated 10 July 2002 and 23 December 2004 have been issued for the station area, basement carpark, retail and residential developments.<br><br>The property is held from the Government under New Grant No. 9694 from 22 October 2002 for 50 years. The annual Government rent payable for the property is an amount equal to 3% of the rateable value of the property. | The commercial space is let on full internal repairing leases and is currently fully occupied.<br><br>The majority of the lease terms are for three years.<br><br>The revenue receivable for the commercial spaces for the month of June 2007 was approximately HK$2,671,000.<br><br>The car parking spaces are currently licensed on monthly and hourly basis.<br><br>The revenue receivable for the car parking spaces for the month of June 2007 was approximately HK$31,000. | HK$459,100,000 |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (17) | 51% Interest of Car Park Development (comprising 450 Public Car Parking Spaces, 46 Ancillary Residential Car Parking Spaces, 8 Ancillary Commercial Car Parking Spaces and 10 Motor Cycle Parking Spaces), Choi Hung Park & Ride, No. 8 Clear Water Bay Road, Kowloon<br><br>6,579/27,422nd equal and undivided shares of and in New Kowloon Inland Lot No. 6179 | The property comprises altogether 504 car parking spaces and 10 motor cycle parking spaces on Levels 2 to 10 (excluding Level 4) of a multi-storey commercial podium within a residential cum commercial development. The development was built in 2005.<br><br>New Kowloon Inland Lot No. 6179 is held from the Government under Conditions of Grant No. 12611 for a term of 50 years commencing on 12 November 2001. The annual Government rent payable for the property is 3% of its rateable value. | The property is currently licensed on monthly and hourly basis since its opening in March 2006.<br><br>The total revenue for the month of June 2007 was approximately HK$376,000. | HK$49,980,000<br><br>(Interests attributable to MTRC) |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (18) | 70% Interest of The Edge and 50 Car Parking Spaces at Grandiose, No. 9 Tong Chun Street, Tseung Kwan O, New Territories<br><br>199,157/991,826th equal and undivided shares of and in Tseung Kwan O Town Lot No. 75 | The property comprises 2 levels of commercial spaces and 50 car parking spaces within a 5-storey retail/car parking/clubhouse podium of the Grandiose development. The development was built in 2006.<br><br>The 2-storeys retail accommodation contains arcade shops and restaurants. As provided, the total lettable area of the property is approximately 82,700ft$^2$ (7,683.02m$^2$).<br><br>The 50 car parking spaces of the property are located on the Mezzanine Floor of the podium.<br><br>Tseung Kwan O Town Lot No. 75 is held from the Government under New Grant No. 9687 for a term of 50 years from 28 March 2002. The annual Government rent payable for the property is 3% of its rateable value. | The property started operation since October 2006.<br><br>The commercial space is let on full internal repairing leases and is currently fully occupied.<br><br>The majority of the lease terms are for three years.<br><br>The revenue receivable for the commercial spaces for the month of June 2007 was approximately HK$3,998,000.<br><br>The car parking spaces are currently licensed on hourly basis since its operation in October 2006.<br><br>The revenue receivable for the car parking spaces for the month of June 2007 was approximately HK$46,000. | HK$509,600,000<br><br>(Interests attributable to MTRC) |

*Note:*

(1) The registered owner of the Property is MTRC.

**Group 2 — Property Interests Held by MTRC for Owner-Occupation**

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (19) | Suites 3301 to 3305 on 33rd Floor, Two International Finance Centre, International Finance Centre, No. 8 Finance Street, Central, Hong Kong<br><br>Portion of Site R of Inland Lot No. 8898 | The property comprises part of the 33rd Floor in Two International Finance Centre, which was completed in 2003.<br><br>According to the information provided, the lettable area of the property is approximately 6,880ft$^2$ (639.2m$^2$).<br><br>Inland Lot No. 8898 is held from the Government under Conditions of Grant No. 12459 for a term from 21 May 1997 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The property is currently occupied by MTRC. | HK$172,000,000 |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (20) | Office No. 2101 on 21st Floor, Worldwide House, No. 19 Des Voeux Road Central, Hong Kong<br><br>369/123,000th equal and undivided share of and in Inland Lot No. 8432. | The property comprises an office unit on the 21st Floor of a 24-storey office tower erected over a 4-level retail podium on top of Central Station. The building was completed around 1981.<br><br>The approximate lettable area of the subject property is 2,422ft$^2$ (225.01m$^2$).<br><br>Inland Lot No. 8432 is held from the Government under Conditions of Grant No.11187 for a term of 75 years from 15 April 1978, renewable for a further term of 75 years. The Government rent payable for the entire lot is HK$1,000 per annum. | The property is currently occupied by MTRC. | HK$32,500,000 |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (21) | MTR Tower and 52 Car Parking Spaces at Telford Plaza, No. 33 Wai Yip Street, Kowloon Bay, Kowloon<br><br>New Kowloon Inland Lot Nos. 6201 and 5744 | Tower 1 of Telford Plaza, or otherwise known as MTR Tower, comprises a 15-storey office tower erected over Telford Plaza II, which is a 4-level retail podium on top of a traffic interchange, 3 levels of carpark and the Kowloon Bay Depot. The building was built in 1996.<br><br>The property comprises Levels L7 to L23 (no designation of Levels L13 and L14) together with an annex immediately above the retail podium and 52 car parking spaces on Levels L1B and L2.<br><br>The total gross saleable area of the office tower is approximately 28,515.74m² (306,943ft²).<br><br>New Kowloon Inland Lot No. 6201 is held from the Government under Conditions of Exchange No.12289 for a term from 12 January 1994 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value.<br><br>New Kowloon Inland Lot No. 5744 is held from the Government under Conditions of Grant No. 11083 for a term of 99 years from 1 July 1898 and had been extended to expire on 30 June 2047. | The property is currently occupied by MTRC. | HK$1,508,000,000 |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) As contained in the area information certified by authorized person as provided by MTRC, the definitions of Gross Saleable Area, Gross Built Area and Gross Built Common Area are as follows:

**Gross Saleable Area** means the aggregate of the Gross Built Area of the property and the apportioned Gross Built Common Area attributable to the property. The Gross Built Common Areas are apportioned to Levels L7 to L23 of Tower 1 of the Building in the same proportion that the respective Gross Built Area of each level shall bear to the total Gross Built Area of the offices at Levels L7 to L23 of Tower 1 of the Building.

**Gross Built Area** in respect of each Level L7 to L23 (inclusive) means the area measured from the exterior of the enclosing walls of each such level which shall include the whole thickness of the enclosing walls except where such enclosing walls abut on Tower 2 in which case the measurement shall be taken to the middle of those walls and in each case shall include the internal partitions, columns and space within enclosing walls.

**Gross Built Common Area** means the common areas at Levels L2 to L6 (both inclusive) of Tower 1 and Tower 1 Annex of the Building. The area of the Gross Built Common Areas shall be measured from the exterior of the enclosing walls of such level and shall include the whole thickness of the enclosing wall and shall include the internal partitions and columns (if any) within enclosing walls.

Towers 1 and 2 stated in the above definitions refer to MTR Tower and Hang Seng Tower respectively.

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (22) | Levels L2, Mezzanine Floor, L8 to L10 and L23 of Hang Seng Tower, Telford Plaza, No. 33 Wai Yip Street, Kowloon Bay, Kowloon<br><br>New Kowloon Inland Lot Nos. 6201 and 5744 | Hang Seng Tower comprises a 15-storey office tower erected over Telford Plaza II, which is a 4-level retail podium on top of a transport interchange, 3 levels of carpark and the Kowloon Bay Depot. The building was built in 1996.<br><br>The property comprises Levels L2, Mezzanine Floor, L8 to L10 and L23 of the tower.<br><br>The total gross saleable area of the property is approximately 8,500.436m$^2$ (91,499ft$^2$).<br><br>New Kowloon Inland Lot No. 6201 is held from the Government under Conditions of Exchange No.12289 for a term from 12 January 1994 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value.<br><br>New Kowloon Inland Lot No. 5744 is held from the Government under Conditions of Grant No. 11083 for a term of 99 years from 1 July 1898 and had been extended to expire on 30 June 2047. | The property is currently occupied by MTRC. | HK$417,000,000 |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) As contained in the area information certified by authorized person as provided by MTRC, the definitions of Gross Saleable Area, Gross Built Area and Gross Built Common Area are as follows:

**Gross Saleable Area** means the aggregate of the Gross Built Area of the property and the apportioned Gross Built Common Area attributable to the property. The Gross Built Common Areas are apportioned to Levels L7 to L23 of Tower 1 of the Building in the same proportion that the respective Gross Built Area of each level shall bear to the total Gross Built Area of the offices at Levels L7 to L23 of Tower 1 of the Building.

**Gross Built Area** in respect of each Level L7 to L23 (inclusive) means the area measured from the exterior of the enclosing walls of each such level which shall include the whole thickness of the enclosing walls except where such enclosing walls abut on Tower 2 in which case the measurement shall be taken to the middle of those walls and in each case shall include the internal partitions, columns and space within enclosing walls.

**Gross Built Common Area** means the common areas at Levels L2 to L6 (both inclusive) of Tower 1 and Tower 1 Annex of the Building. The area of the Gross Built Common Areas shall be measured from the exterior of the enclosing walls of such level and shall include the whole thickness of the enclosing wall and shall include the internal partitions and columns (if any) within enclosing walls.

Towers 1 and 2 stated in the above definitions refer to MTR Tower and Hang Seng Tower respectively.

**Group 3 — Property Interests Held by MTRC for Sale**

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (23) | Commercial Development and 579 Residential, 117 Office and 330 Commercial Car Parking Spaces at Olympian City One and Island Harbourview, Various Unsold Flats at Island Harbourview, Olympic Station, No. 11 Hoi Fai Road, and Kindergarten and Various Unsold Flats and Car Parking Spaces at Harbour Green, No. 8 Sham Mong Road, Kowloon<br><br>Portions of Kowloon Inland Lot No. 11074 and Kowloon Inland Lot No. 11151 | The property comprises 3-storeys retail accommodation and various car parking spaces of a multi-storey commercial podium provided with shopping arcades, car park and recreational facilities within a commercial and residential development ("Property A"). The development was built in phases in 1999 and 2000.<br><br>As provided, the total lettable area of Property A is approximately 65,035 $ft^2$ (6,041.90 $m^2$).<br><br>The property also comprise various unsold flat at Island Harbourview ("Property B"). The residential development at Island Harbourview comprises 9 tower blocks and accommodates a total of 2,314 domestic units and 579 residential car parking spaces. The residential development was built in 2000.<br><br>The total gross floor area of Property B is approximately 3,237$ft^2$ (300.72$m^2$).<br><br>In addition, the property comprise a kindergarten ("Property C") within a multi-storey podium and various unsold flats and car parking spaces of Harbour Green ("Property D") which is a residential development at the north east of Olympic Station. The residential development comprise 5 tower blocks and accommodates a total of 1,514 domestic units and 264 residential car parking spaces. The residential development was built in 2006.<br><br>The gross floor area of Property C is approximately 13,983$t^2$ (1,299$m^2$).<br><br>Property D comprises 112 flats and 163 car parking spaces. The total gross floor area is approximately 121,458$ft^2$ (11,283.72$m^2$). | The commercial space of Property A is let on full internal repairing leases and approximately 90% of the floor space is occupied.<br><br>The majority of the lease terms are for two to three years.<br><br>The total revenue receivable for the commercial space of Property A for the month of July 2007 was approximately HK$2,293,000.<br><br>The residential and commercial car parking spaces are currently licensed on monthly and hourly basis, whilst the office car parking spaces are vacant.<br><br>Property B is currently vacant.<br><br>Property C is currently vacant and under decoration.<br><br>Property D is currently vacant. | HK$613,300,000 |

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (23) | Commercial Development and 579 Residential, 117 Office and 330 Commercial Car Parking Spaces at Olympian City One and Island Harbourview, Various Unsold Flats at Island Harbourview, Olympic Station, No. 11 Hoi Fai Road, and Kindergarten and Various Unsold Flats and Car Parking Spaces at Harbour Green, No. 8 Sham Mong Road, Kowloon<br><br>(cont'd) | Kowloon Inland Lot No. 11074 is held from the Government under Conditions of Grant No. 12375 from 31 January 1996 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value.<br><br>Kowloon Inland Lot No. 11151 is held from the Government under Conditions of Exchange No. 12620 for a term of 50 years from 4 March 2002. The annual Government rent payable for the property is 3% of its rateable value. | — | — |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) MTRC's ownership interests in the components of this property are in the range of 35% to 100%.

**Group 3 — Property Interests Held by MTRC for Sale**

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (24) | Various Unsold Residential Units, Car Parking Spaces and Motor Cycle Parking Spaces at<br><br>• The Grandiose, No. 9 Tong Chun Street, Tseung Kwan O, New Territories<br><br>• Central Heights, No. 9 Tong Tak Street, Tseung Kwan O, New Territories<br><br>Portions of Tseung Kwan O Town Lots Nos. 74 and 75 | The Grandiose is a residential development at the eastern side of Tseung Kwan O Station. It comprises 3 tower blocks and accommodates a total of 1,472 domestic units and 184 residential car parking spaces. The residential development was built in 2006.<br><br>Central Heights comprises a residential tower at the western side of Tseung Kwan O Station. It accommodates a total of 390 domestic units and 54 residential car parking spaces. The residential development was built in 2005.<br><br>Recreational facilities such as swimming pools, landscaped garden and gymnasium are provided within the two developments.<br><br>The subject property comprises 11 and 22 unsold residential units in The Grandiose and Central Heights respectively. The total number of car parking spaces and motor cycle parking spaces are 203 and 29 respectively. The total gross floor area of the residential units is approximately 25,961ft$^2$ (2,411.84m$^2$).<br><br>Tseung Kwan O Town Lot No. 74 is held from the Government under New Grant No. 9686 for a term of 50 years from 28 March 2002. The annual Government rent payable for the property is 3% of its rateable value.<br><br>Tseung Kwan O Town Lot No. 75 is held from the Government under New Grant No. 9687 for a term of 50 years from 28 March 2002. The annual Government rent payable for the property is 3% of its rateable value. | The property is currently vacant. | HK$83,900,000 |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) MTRC's ownership interests in the components of this property are in the range of 35% to 70%.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (25) | Various Unsold Residential Units and Car Parking Spaces at The Arch, No. 1 Austin Road West, Kowloon<br><br>Portions of Kowloon Inland Lot No. 11080 (Site C) | The Arch, being part of the Kowloon Station Development, is a residential development comprising 2 twin blocks and accommodating a total of 1,054 domestic units and 412 residential car parking spaces. The residential development was built in 2005.<br><br>The subject property comprises 69 unsold residential units and 94 car parking spaces in The Arch. The total gross floor area of the residential units is approximately 121,715ft$^2$ (11,307.60m$^2$).<br><br>Kowloon Inland Lot No. 11080 is held from the Government under Conditions of Grant No. 12397 for a term from 8 July 1996 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The property is currently vacant. | |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (26) | Various Car Parking Spaces and Motor Cycle Parking Spaces at Residence Oasis, No. 15 Pui Shing Road, Tseung Kwan O, New Territories<br><br>Portions of Tseung Kwan O Town Lot No. 24 | Residence Oasis is a residential development at Hang Hau Station. It comprises 6 tower blocks and accommodates a total of 2,130 domestic units and 321 residential car parking spaces. The residential towers were built in 2004. Basements 1, 2 and 3 and Ground Floor of the development were built in 2002.<br><br>The subject property comprises 195 car parking spaces and 18 motor cycle parking spaces in Residence Oasis.<br><br>Tseung Kwan O Town Lot No. 24 is held from the Government under New Grant No. 9694 for a term of 50 years from 22 October 2002. The annual Government rent payable for the property is 3% of its rateable value. | The property is currently vacant. | |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (27) | Various Unsold Residential Units, Car Parking Spaces and Motor Cycle Parking Spaces Metro Town, No. 8 King Ling Road, Tseung Kwan O, New Territories<br><br>Portions of Tseung Kwan O Town Lot No. 73 | Metro Town is a residential development erected at Tiu Keng Leng Station. It comprises 4 tower blocks and accommodates a total of 1,676 domestic units and approximately 217 residential car parking spaces. The residential development was built in 2006.<br><br>The subject property comprises 24 unsold residential units, 217 car parking spaces and 33 motor cycle parking spaces in Metro Town. The total gross floor area of the residential units is approximately 23,466ft$^2$ (2,180.04m$^2$).<br><br>Tseung Kwan O Town Lot No. 73 is held from the Government under New Grant No. 9700 for a term of 50 years from 11 February 2003. The annual Government rent payable for the property is 3% of its rateable value. | The property is currently vacant. | |

*Note:*

(1) The registered owner of the property is MTRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 *(HK$)* |
|---|---|---|---|---|
| (28) | Various Unsold Residential Units and Car Parking Spaces at Caribbean Coast, Tung Chung<br><br>Portions of Tung Chung Town Lot No. 5 | Caribbean Coast is a residential development erected on a site bounded by Ying Hei Road, Man Tung Road and Yi Tung Road in Tung Chung. The development comprises high rise towers and town houses accommodating a total of 5,336 domestic units and 1,185 car parking spaces. Phases 1 to 4 was built from 2002 to 2006 and Phase 5 is scheduled to be completed in 2008.<br><br>The subject property comprises 23 unsold residential units and 711 car parking spaces in Caribbean Coast. The total gross floor area of the residential units is approximately 17,211ft$^2$ (1,598.94m$^2$).<br><br>Tung Chung Town Lot No. 5 is held from the Government under Conditions of Grant No. 8102 for a term from 26 June 1997 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The property is currently vacant. | |

*Note:*

(1) The registered owner of the property is MTRC.

**Total for Property 25 to Property 28: HK$998,600,000****

** MTRC's ownership interests in Property 25 to Property 28 are in the range of 20% to 72%.

**Group 4 — Property Interests Held by MTRC for Investment Under Construction**

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (29) | The Interest in Retail Accommodation and Kindergarten (Site E), Cross Border Coach Terminus (Site C) and 898 Car Parking Spaces, Kowloon Station, No. 1 Austin Road West, Kowloon<br><br>Portion of Kowloon Inland Lot No. 11080 | The property forms part of the Kowloon Station Development.<br><br>The development is situated on the reclamation area in South West Kowloon. The entire development, upon completion, will comprise 16 residential towers, 2 mixed-use (hotel/serviced apartment/residential) towers, a 118-storey landmark office and hotel tower and a shopping centre.<br><br>The Retail Accommodation and the kindergarten are located at the podium above Kowloon Station. The Retail Accommodation, will provide retail and dining spaces, a 12-screen cinema, an ice-skating rink and 898 car parking spaces. Phase 1, Phase 2 and Phase 3 of the Retail Accommodation is scheduled to open in October 2007, May 2008 and around 2010 to 2011 respectively. | Fitting out works are currently undertaken at the Retail Accommodation and the Cross Border Coach Terminus. The marketing campaign of the retail accommodation has been launched. Various tenancies have been committed for the Retail Accommodation.<br><br>The kindergarten has been let for a term of 4 years commencing in May 2007. | HK$6,621,000,000 |

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (29) | The Interest in Retail Accommodation and Kindergarten (Site E), Cross Border Coach Terminus (Site C) and 898 Car Parking Spaces, Kowloon Station, No. 1 Austin Road West, Kowloon<br><br>(cont'd) | The gross floor area (excluding areas dedicated for public passage) of Phase 1, Phase 2 and Phase 3 of the Retail Accommodation is approximately 797,236ft$^2$ (74,065m$^2$), 81,903ft$^2$ (7,609m$^2$) and 11,582ft$^2$ (1,076m$^2$) respectively. | — | — |

| Use | Gross Floor Area (ft$^2$) | Gross Floor Area (m$^2$) |
|---|---|---|
| Retail Accommodation [(1)] | 890,721 | 82,750 |
| Cross Border Coach Terminus | 55,036 | 5,113 |
| Kindergarten [(2)] | 11,247 | 1,045 |

*Notes:*

*(1) Excluding the areas which are dedicated for public passage.*

*(2) Plus an outdoor courtyard of approximately 3,667ft$^2$ (341m$^2$) and chiller plant room of approximately 660ft$^2$ (61m$^2$).*

The Cross Border Coach Terminus is located on G/F, 1/F, 2/F and 2M/F of the podium at Site C of the lot.

Kowloon Inland Lot No. 11080 is held from the Government under Conditions of Grant No. 12397 for a term from 8 July 1996 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value.

*Notes:*

(1) The registered owner of the property is MTRC.

(2) The property is zoned "Comprehensive Development Area" under the Draft South West Kowloon Outline Zoning Plan No. S/K20/19 exhibited on 18 May 2007.

(3) MTRC's ownership interests in the components of this property are in the range of 81% to 100%.

**Group 5 — Property Interests Held by MTRC for Development (Packages Awarded)**

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (30) | Coastal Skyline and Caribbean Coast (Excluding the Whole of Towers 6, 7, 16, Portion of Tower 15 and 285 Car Parking Spaces), Tung Chung, Lantau Island<br><br>Tung Chung Town Lot Nos. 4 and 5 | The property comprises the Coastal Skyline development ("Property A") and majority portion of the Caribbean Coast development ("Property B").<br><br>The Coastal Skyline development is erected upon a site with an area of approximately 685,667ft$^2$ (63,700m$^2$) bounded by Tung Chung Waterfront Road, Yi Tung Road, Man Tung Road and Wai Tung Road in Tung Chung of the Lantau Island.<br><br>Property A comprises mainly residential units with certain commercial spaces to support the local community. The whole development is divided into four phases. The total maximum residential gross floor area permitted under lease as modified by a modification letter dated 3 May 2000 is 253,100m$^2$ (2,724,368ft$^2$). In addition, the gross floor area permitted under lease for the retail portion and kindergarten is 2,500m$^2$ (26,910ft$^2$) and 350m$^2$ (3,767ft$^2$) respectively.<br><br>The key components of the residential portion are as follows: | Part of the residential units have been sold. The unsold units are currently vacant.<br><br>The commercial portion of the development is currently let to various tenants. | HK$137,000,000 |

| | Description | Flat Nos. |
|---|---|---|
| Phase 1 | 5 High-rise towers (Tower 1, Tower 2, Tower 3, Tower 5 & Tower 6) | 2,022 |
| Phase 2 | Le Bleu (Town Houses) | 41 |
| Phase 3 | La Rossa (Tower 7 & Tower 8) | 783 |
| Phase 4 | 6 Low-rise blocks | 524 |
| | **Total** | 3,370 |

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (30) | Coastal Skyline and Caribbean Coast (Excluding the Whole of Towers 6, 7, 16, Portion of Tower 15 and 285 Car Parking Spaces), Tung Chung, Lantau Island<br><br>(cont'd) | As per the building plan approved by the Building Authority on 19 April 2007, the total number of car parking spaces to be provided in the development is 625 nos., among which 63 nos. are devoted for retail uses and 82 nos. are provided for town houses.<br><br>Phase 1 to Phase 3 have been completed at the following Occupation Permit dates:<br><br>**Occupation Permit Date**<br>Phase 1 — 12 September 2002<br>Phase 2 — 7 February 2005<br>Phase 3 — 27 October 2006<br><br>Phase 4 is currently under construction and expected to be completed by 2007.<br><br>The Caribbean Coast development is erected on a site with area of approximately 730,876ft$^2$ (67,900m$^2$) bounded by Ying Hei Road, Man Tung Road and Yi Tung Road in Tung Chung of the Lantau Island.<br><br>Property B comprises mainly residential units with a commercial complex at podium floor to support the local community within Caribbean Coast. The whole development is divided into five phases. The maximum residential gross floor area permitted under lease as modified by a modification letter dated 3 May 2000 is 407,300m$^2$ (4,384,177ft$^2$).<br><br>For the purpose of valuation, 105,600m$^2$ residential gross floor area, i.e. the whole of Towers 6, 7 & 16 and Portion of Tower 15 is excluded. | — | — |

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (30) | Coastal Skyline and Caribbean Coast (Excluding the Whole of Towers 6, 7, 16, Portion of Tower 15 and 285 Car Parking Spaces), Tung Chung, Lantau Island<br><br>(cont'd) | In addition, the gross floor area for the retail portion and kindergarten is 5,000m$^2$ (53,820ft$^2$) and not less than 350m$^2$ (3,767ft$^2$) respectively.<br><br>The key components of the residential portion are as follows: | — | — |

| | Description | Flat Nos. |
|---|---|---|
| Phase 1 | Monterey Cove (Tower 1, Tower 2, Tower 3 & Tower 5) | 1,552 |
| Phase 2 | Albany Cove (Tower 6, Tower 7 & Tower 8) | 1,240 |
| Phase 3 | Carmel Cove (Tower 9, Tower 10, Tower 11 & Tower 12) | 1,664 |
| Phase 4 | Crystal Cove (Tower 15 & Tower 16) | 824 |
| Phase 5 | Town houses | 56 |
| | **Total** | 5,336 |

The total number of car parking spaces to be provided in the development is 1,185 nos., among which 117 nos. are devoted for retail uses. For the purpose of valuation, 285 nos. of car parking spaces are excluded.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (30) | Coastal Skyline and Caribbean Coast (Excluding the Whole of Towers 6, 7, 16, Portion of Tower 15 and 285 Car Parking Spaces), Tung Chung, Lantau Island<br><br>(cont'd) | Phase 1 to Phase 4 have been completed at the following Occupation Permit dates:<br><br>**Occupation Permit Date**<br>Phase 1 — 19 December 2002<br>Phase 2 — 30 September 2004<br>Phase 3 — 5 July 2005<br>Phase 4 — 25 September 2006<br><br>Phase 5 is currently under construction and expected to be completed in 2008.<br><br>Tung Chung Town Lot No. 4 for Property A is held under Conditions of Grant via New Grant No. 8082 for a term from 26 March 1997 to 30 June 2047. The annual Government rent payable for the lot is 3% of its rateable value.<br><br>Tung Chung Town Lot No. 5 for Property B is held under Conditions of Grant via New Grant No. 8102 for a term from 26 June 1997 to 30 June 2047. The annual Government rent payable for the lot is 3% of its rateable value. | — | — |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) The development package in respect of Coastal Skyline has been awarded to a consortium led by HKR International Ltd.

(3) The development package in respect of Caribbean Coast has been awarded to a subsidiary of Cheung Kong (Holdings) Limited and Hutchison Whampoa Ltd.

(4) The property is zoned "Comprehensive Development Area" under the Tung Chung Town Centre Area Outline Zoning Plan No. S/I-TCTC/14 approved on 3 January 2006.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (31) | Packages One and Two, Tseung Kwan O Area 86, Tseung Kwan O, New Territories<br><br>Site F and Site AB of Tseung Kwan O Town Lot No. 70 | The property comprises two packages within Tseung Kwan O Area 86.<br><br>Package One comprises an elongated site with a site area of approximately 153,570ft$^2$ (14,267m$^2$) near the junction of Shek Kok Road and Wan Po Road on the southeastern side of Tseung Kwan O Depot. The proposed development at the property is a residential development comprising five blocks with retail space and a residential care home for the elderly ("RCHE").<br><br>A community hall and an integrated children and youth services centre will be provided.<br><br>The total gross floor area of the proposed development in Package One is approximately 1,505,238ft$^2$ (139,840m$^2$). 300 residential car parking spaces will be provided at the proposed development. | The developments in Packages One and Two are currently under construction as at the date of valuation.<br><br>Practical completion of Packages One and Two are scheduled in 2009 and 2011 respectively. | HK$4,788,000,000 |

| Use | Gross Floor Area | |
|---|---|---|
| | *(m$^2$)* | *(ft$^2$)* |
| Residential | 136,240 | 1,466,487 |
| Retail | 500 | 5,382 |
| RCHE | 3,100 | 33,368 |
| **Total** | 139,840 | 1,505,237 |

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (31) | Packages One and Two, Tseung Kwan O Area 86, Tseung Kwan O, New Territories<br><br>(cont'd) | Package Two comprises a site with area of approximately 338,958ft$^2$ (31,490m$^2$) on the southeastern side of Tseung Kwan O Depot.<br><br>The site is to be developed into a residential development comprising 10 residential towers with about 4,272 units, 800m$^2$ kindergarten and 855 residential car parking spaces. The total gross floor area of the proposed development on the property is approximately 3,342,179ft$^2$ (310,496m$^2$). | — | — |

| Use | Gross Floor Area (m$^2$) | (ft$^2$) |
|---|---|---|
| Residential | 309,696 | 3,333,568 |
| Kindergarten * | 800 | 8,611 |
| **Total** | 310,496 | 3,342,179 |

* *The kindergarten is non-GFA accountable.*

Tseung Kwan O Town Lot No. 70 is held from the Government under New Grant No. 9689 for a term of 50 years commencing on 16 May 2002. The annual Government rent payable for the lot is 3% of its rateable value.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (31) | Packages One and Two, Tseung Kwan O Area 86, Tseung Kwan O, New Territories<br><br>(cont'd) | Land premium for Package One was settled at HK$2,319,290,000. Land premium of HK$71,890,680 was settled for consent for exempting the balcony and utility platform from gross floor area calculation.<br><br>Land premium for Package Two was settled at HK$8,061,470,000. Land premium of HK$159,244,935 was settled for consent for exempting the balcony and utility platform from gross floor area calculation.<br><br>Land premium of HK$20,000,000 was settled for a lease modification for the entire lot dated 13 April 2006. | — | — |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) Tseung Kwan O Area 86 Package One has been awarded to a subsidiary of Cheung Kong (Holdings) Limited.

(3) Tseung Kwan O Area 86 Package Two has been awarded to a subsidiary of Cheung Kong (Holdings) Limited.

(4) The property is zoned "Comprehensive Development Area" under the Tseung Kwan O Outline Zoning Plan No. S/TKO/15 approved on 2 November 2004. The application for permission under the Town Planning Ordinance for master layout plan of the whole lot was approved by the Town Planning Board as per an approval letter dated 1 December 2006.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (32) | The Interest in The Harbourside (Site D), Kowloon Station, No. 1 Austin Road West, Kowloon<br><br>Portion of Kowloon Inland Lot No. 11080 | The property forms part of the Kowloon Station Development.<br>The development is situated on the reclamation area in South West Kowloon. The entire development, upon completion, will comprise 16 residential towers, 2 mixed-use (hotel/serviced apartment/residential) towers, a 118-storey landmark office and hotel tower and a shopping centre.<br><br>The Harbourside comprises three 70-storey residential towers over an 5-level podium for car park, clubhouse and entrance lobby. Car parking spaces are located on G/F, GM/F, 1/F, 2/F and 2M/F. The residential development was built in 2003.<br><br>The total number of flats and car parking spaces provided is 1,122 and 864 respectively. The total gross floor area under lease is approximately 1,386,888ft$^2$ (128,845m$^2$). | Part of the residential units and car parking spaces were sold as at the date of valuation. The unsold units and car parking spaces of The Harbourside are currently vacant. | |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) The development package in respect of the property has been awarded to a subsidiary of Hang Lung Properties Limited.

(3) The property is zoned "Comprehensive Development Area" under the Draft South West Kowloon Outline Zoning Plan No. S/K20/19 exhibited on 18 May 2007.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (33) | Tiu Keng Leng, Phase 2, Tseung Kwan O New Territories<br><br>Portion of and in Tseung Kwan O Town Lot No. 73 | The property comprises Phase 2 of the development at Tseung Kwan O Town Lot No. 73, having a registered site area of approximately 348,043ft$^2$ (32,334m$^2$). The site adjoins Tiu Keng Leng Station and is divided into Site A and Site B.<br><br>The development at Tseung Kwan O Town Lot No. 73 comprises the Public Transport Interchange and 9 residential towers with commercial and car parking podium.<br><br>Phase 1 of the development, known as Metro Town, comprises Towers 1, 2, 3 & 5 and 217 residential car parking spaces.<br><br>Phase 2, known as Le Point, includes Towers 6, 7, 8, 9 & 10 and 270 residential car parking spaces.<br><br>According to the information available to us, the residential development of the property will be in the form of 52 to 53-storey residential blocks. A total of 2,096 flats and 270 residential car parking spaces will be provided. Retail and recreational areas will also be provided at the development.<br><br>The total gross floor area of the property is approximately 1,402,958ft$^2$ (130,338m$^2$).<br><br>Tseung Kwan O Town Lot No. 73 is held from the Government under New Grant No. 9700 for a term of 50 years commencing on 11 February 2003. The annual Government rent payable for the lot is 3% of its rateable value. | Construction of the property commenced in July 2005. The property is under construction as at the date of valuation. Practical completion is scheduled in 2008. | |

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (33) | Tiu Keng Leng, Phase 2, Tseung Kwan O New Territories<br><br>(cont'd) | Land premium of HK$1,227,840,000 for Site B of Tseung Kwan O Town Lot No. 73 was settled on 10 February 2004.<br><br>Land premium of HK$310,000 was settled for lease modification as per modification letter dated 18 December 2004.<br><br>Land premium of HK$83,198,620 was settled for consent as per consent letter on 11 April 2005 for exempting the balcony and utility platform of Site A and Site B of the lot from gross floor area calculation. | — | — |

*Notes:*

(1) The registered owner of the Property is MTRC.

(2) The development package in respect of the property has been awarded to a subsidiary of Cheung Kong (Holdings) Limited.

(3) The property is zoned "Other Specified Uses" annotated "Commercial / Residential Development with Public Transport Interchange" under the Tseung Kwan O Outline Zoning Plan No. S/TKO/15 approved on 2 November 2004.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (34) | Tseung Kwan O Area 56, Tseung Kwan O Station, Tseung Kwan O, New Territories<br><br>Tseung Kwan O Town Lot No. 72 | The property comprises a site with an area of approximately 430,452ft$^2$ (39,990m$^2$) bounded by Po Yap Road, Tong Yin Street, Tong Tak Street and Tong Chun Street in the Tseung Kwan O district.<br><br>The proposed development comprises composite residential/commercial/hotel/office uses at the Tseung Kwan O Station and a covered Public Transport Interchange. The total gross floor area of the proposed development is approximately 1,814,132ft$^2$ (168,537m$^2$). | Except the Tseung Kwan O Station and the Public Transport Interchange, the rest of the property is a vacant development site as at the date of valuation.<br><br>The development of the property is scheduled to commence in 2007 and practical completion of the retail centre is expected in 2011. | |

| Use | Gross Floor Area | | Parking Spaces |
|---|---|---|---|
| | *(m$^2$)* | *(ft$^2$)* | *(no.)* |
| Residential | 80,000 | 861,120 | 165 |
| Hotel | 58,130 | 625,711 | 28 |
| Retail | 20,000 | 215,280 | 110 |
| Office | 5,000 | 53,820 | 40 |
| GIC* | 5,407 | 58,201 | — |
| **Total** | 168,537 | 1,814,132 | 343 |

* Government, Institution or Community

Tseung Kwan O Town Lot No. 72 is held from the Government under New Grant No. 20379 for a term of 50 years commencing on 18 May 2007. The annual Government rent payable for the lot is 3% of its rateable value.

Land premium of HK$3,345,230,000 was settled for the lot.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (34) | Tseung Kwan O Area 56, Tseung Kwan O Station, Tseung Kwan O, New Territories<br><br>(cont'd) | — | — | — |

*Notes:*

(1) The application for permission under section 16 of the Town Planning Ordinance for the above proposed development parameters were approved by the Town Planning Board as per the approval letter dated 13 January 2006. The land grant has been obtained from the Government. No approval from Building Authority has been obtained as at date of valuation.

(2) The development package in respect of the property has been awarded to a subsidiary of Sun Hung Kai Properties Limited.

(3) The property is zoned "Other Specified Uses" annotated "Commercial Development with Public Transport Interchange" under the Tseung Kwan O Outline Zoning Plan No. S/TKO/15 approved on 2 November 2004.

**Total for Property 32 to Property 34: HK$6,527,000,000**

**Total for Property 30 to Property 34: HK$11,452,000,000****

** MTRC's share of development profits for all property interests held for development (packages awarded) is in the range of 11% to 85%.

**Group 6 — Property Interests Held by MTRC for Development (Packages to be Awarded)**

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (35) | Packages Three to Thirteen (Maximum) Tseung Kwan O Area 86, Tseung Kwan O, New Territories<br><br>Sites C, D, E, G, H, I, J, K, L, N and O of Tseung Kwan O Town Lot No. 70 | The property is part of Tseung Kwan O Town Lot No. 70 ("TKOTL 70"), which adjoins the Tseung Kwan O Depot. The total site area of TKOTL 70 is approximately 326,751m$^2$ (3,517,148ft$^2$). The sites within the subject property are scheduled to be developed into a mixed residential/ commercial development comprising 35 residential towers with about 15,132 units, commercial accommodation and ancillary facilities. The maximum total gross floor area and number of car parking spaces to be provided at the proposed development on the sites is approximately 12,951,934ft$^2$ (1,203,264m$^2$) and 3,653 (including 175 visitor spaces) respectively.<br><br>Tseung Kwan O Town Lot No. 70 is held from the Government under New Grant No. 9689 for a term of 50 years commencing on 16 May 2002. The annual Government rent payable for the lot is 3% of its rateable value.<br><br>Land premium of HK$20,000,000 was settled for a lease modification for the entire lot dated 13 April 2006. | The property is currently vacant as at the date of valuation.<br><br>Practical completion for the various sites is scheduled between 2012 and 2015. | |

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (35) | Packages Three to Thirteen (Maximum) Tseung Kwan O Area 86, Tseung Kwan O, New Territories<br><br>(cont'd) | — | — | — |

*Notes:*

(1) The registered owner of the property is MTRC.

(2) The total gross floor area and number of car parking spaces of the development for the various sites as stipulated under the lease conditions is set out as follows:

| Site | Minimum Residential Gross Floor Area | | Minimum No. of Flats | Commercial Gross Floor Area | |
|---|---|---|---|---|---|
| | *(m²)* | *(ft²)* | | *(m²)* | *(ft²)* |
| C | 118,560 | 1,276,180 | 1,697 | Min. 28,980 | Min. 311,941 |
| D | 118,560 | 1,276,180 | 1,697 | | |
| E | 106,600 | 1,147,442 | 1,526 | | |
| G | 85,800 | 923,551 | 1,228 | | |
| H | 81,640 | 878,773 | 1,168 | Max. 1,200 | Max. 12,917 |
| I | 52,520 | 565,325 | 751 | | |
| J | 87,360 | 940,343 | 1,250 | | |
| K | 59,280 | 638,090 | 848 | | |
| L | 57,200 | 615,701 | 819 | | |
| N | 114,140 | 1,228,603 | 1,633 | | |
| O | 101,920 | 1,097,067 | 1,459 | | |
| Sub-Total | 983,580 | 10,587,255 | 14,076 | Min. 28,980 | Min. 311,941 |

No. of Car Parking Spaces:

Residential car parking spaces for the whole Tseung Kwan O Town Lot No. 70: Minimum: 2,857, Maximum: 4,300

Car Parking Spaces for commercial accommodation on the whole Tseung Kwan O Town Lot No. 70: 333

(3) The sites will be awarded in packages. Tentatively, they will be awarded in a maximum of 11 packages. The development packages in respect of the property have not yet been awarded at the moment.

(4) The property is zoned "Comprehensive Development Area" under the Tseung Kwan O Outline Zoning Plan No. S/TKO/15 approved on 2 November 2004. The application for permission under the Town Planning Ordinance for the master layout plan of the whole lot was approved by the Town Planning Board as per an approval letter dated 1 December 2006.

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (36) | Tsing Yi Lorry Park, No. 31 Tsing King Road, Tsing Yi, New Territories<br><br>Tsing Yi Town Lot No. 135 | The property comprises a site with an area of approximately 164,689ft$^2$ (15,300m$^2$).<br><br>A 2-storey structure is erected on the property providing a pubic lorry park on Level 1 and an open-air public transport terminus ("PTT") on Level 2 above on the podium level.<br><br>The public lorry park comprises 110 lorry parking spaces, whilst the PTT provides a bus terminus and a green minibus terminus. There are 4 footbridge connections from the property to Tsing Yi Station, Maritime Square and nearby residential developments. The property was completed in 1998.<br><br>A proposed conversion of the western portion of the structure into a 4-level commercial complex was approved by the Town Planning Board on 29 September 2006. The number of lorry parking spaces would be reduced from 110 to 60, out of which 10 spaces would be used for day-time commercial loading/ unloading and night-time parking purposes. | The public lorry park is currently operated by Shinta Limited, the developer of the structure, under an operating agreement dated 1 November 2000 for a term of 8 years commencing on 1 November 2000 and expiring on 31 October 2008.<br><br>The conversion has been tentatively scheduled to commence in 2009 and expected to be completed in 2011. | |

| | Property | Description, age and tenure | Particulars of occupancy | Market value of the property interest attributable to MTRC as at 31 July 2007 |
|---|---|---|---|---|
| (36) | Tsing Yi Lorry Park, No. 31 Tsing King Road, Tsing Yi, New Territories<br><br>(cont'd) | The proposed gross floor area of the commercial space upon conversion is 10,500 $m^2$.<br><br>According to the planning paper submitted for approval, the proposed development will comprise 4 levels and 1 mezzanine floor. 60 lorry parking spaces, 65 ancillary private car parking spaces and 21 motorcycle parking spaces will be provided at the development.<br><br>The lot is held from the Government under New Grant No. 7040 for a term from 18 September 1996 to 30 June 2047. The annual government rent payable for the property is 3% of its rateable value. | — | — |

*Notes:*

(1) The registered owner of TYTL 135 is MTRC.

(2) The property is zoned "Government, Institution or Community (1)" under the Tsing Yi Outline Zoning Plan No. S/TY/22 approved on 17 October 2006.

(3) For the purpose of the valuation of the development profit attributable to MTRC from the conversion of the existing lorry park, we have assumed that the lease conditions of New Grant No. 7040 will be modified to reflect the permitted development parameters in the planning submission approved on 29 September 2006.

**Total for Property 35 to Property 36: HK$5,423,000,000****

** MTRC's share of development profit for property interests held for future development in Property 35 is assumed to be in the range of 30% to 50%. Property 36 is assumed for self-development by MTRC.

**Group 7 — Other Property Interests of the MTRC**

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (37) | 2 Leased Office Premises in the United Kingdom and 8 Leased Office Premises in The PRC | The properties comprise the following:<br><br>• 2 leased office premises in the United Kingdom, with a total gross floor area of approximately 3,875ft$^2$ (360.0m$^2$). The total rent is approximately £130,400 per year.<br><br>• 8 leased office premises in the PRC, with a total gross floor area of approximately 66,865.9ft$^2$ (6,212m$^2$). The total rent is approximately RMB 719,400 per month.<br><br>The properties are held under various tenancy agreements for various durations from approximately seven months to five years. | The properties are currently occupied by MTRC as offices. | No commercial value |

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (38) | Interest in Ginza Mall, No.48 Dongzhimenwai Main Street, Beijing, The People's Republic of China | The property comprises a 5-level retail podium currently known as "銀座 Mall (Ginza Mall)" over the Dongzhimen Subway Station.<br><br>The property is situated within a mixed-use development known as "東方銀座廣場 (Oriental Kenzo Plaza)" completed in about 2003.<br><br>Total lettable area of the property as provided is approximately 19,295m$^2$ (207,691ft$^2$).<br><br>According to a tenancy agreement dated 18 January 2006 between 東方銀座廣場有限公司 (Oriental Kenzo Plaza Co. Ltd.) ("Party A") and 港鐵（北京）商業設施管理有限公司 (MTR Corporation (Beijing) Commercial Facilities Management Limited) ("Party B") (the "Tenancy Agreement"), Party B leased the property for a term of 20 years from 1 April 2006 to 31 March 2026 and has options to renew for a further term of 20 years from 1 April 2026 to 31 March 2046 and a further term of 7 years from 1 April 2046 to 31 March 2053.<br><br>The current monthly rent payable by Party B to Party A under the Tenancy Agreement is RMB4,166,667. | Over 99% of the property was leased. The property is currently let by Party B (as Head Lessee) to various sub-tenants.<br><br>The total rent and licence fee of the tenanted spaces (inclusive of the pre-committed spaces) is approximately RMB5,333,000 per month, exclusive of property management fee as at May 2007. | HK$84,000,000<br><br>(Interests attributable to MTRC) |

*Notes:*

(1) According to the Land Use Rights Certificate 京市東港澳台國用(2004出)字第10223號 and the Realty Title Certificate 京房權証市東港澳台字第10231號 both dated 23 April 2004, the property is held by 東方銀座廣場有限公司 (Oriental Kenzo Plaza Co. Ltd.).

(2) 港鐵(北京)商業設施管理有限公司 (MTR Corporation (Beijing) Commercial Facilities Management Limited) is a wholly owned subsidiary of MTRC.

(3) We have in the course of the valuation, accepted and taken into account a report provided by Messrs. Baker & McKenzie to MTRC dated 5 June 2007:

— Party B is entitled at any time during the lease to sub-let without Party A's consent, provided that the area involved does not exceed 3,000 square metres and is intended for use as a shopping centre.

— Party B is entitled to assign the lease/sub-let the entire premises at any time during the lease with Party A's prior consent. Party A is required not to unreasonably withhold consent.

| | Property | Description, age and tenure | Particulars of occupancy | Market value as at 31 July 2007 |
|---|---|---|---|---|
| (38) | Interest in Ginza Mall, No.48 Dongzhimenwai Main Street, Beijing, The People's Republic of China<br><br>(cont'd) | — | — | — |

— After 5 years from the commencement of the lease, Party B is entitled to transfer the lease ( i.e. both its rights and obligations) subject to Party A approving the person to whom the transfer is made.

(4) According to a due-diligence report prepared by MTRC's PRC legal adviser, Messrs. King & Wood dated 2 September 2005, Party A was the legal owner of the property.

(5) The property has been valued in Renminbi and the valuation has been translated into Hong Kong Dollars at the rate of exchange prevailing on the date of valuation at RMB0.97 to HK$1.

**Group 8 — Property Interests Held by KCRC for Investment**

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (39) | Commercial Accommodation, Kindergarten, 20 Residential Units and 20 Car Parking Spaces, Royal Ascot, No. 1 Tsun King Road, Shatin, New Territories<br><br>10,204/265,814th equal and undivided share of and in Sha Tin Town Lot No. 411 (see note (3) below) | Royal Ascot is a composite development comprising ten 33 to 40-storey residential blocks built over a commercial and car park podium. It is located above the KCRC Depot and the KCRC Racecourse Station. The development was completed between 1995 (Phase I) and 1996 (Phase II).<br><br>The property comprises a commercial accommodation (also known as Plaza Ascot) which is a single-storey shopping arcade located on the ground level of Royal Ascot, a kindergarten located towards the end of the driveway off Lok Shun Path, adjacent to the residential car park and 20 residential units located within Blocks 1, 2, 3, 6 and 7 and 20 car parking spaces.<br><br>According to the tenancy schedule provided to us, the total gross floor area of the commercial accommodation is approximately 107,755ft$^2$ (10,010.68m$^2$), including the kindergarten of approximately 8,073ft$^2$ (750m$^2$). | The commercial accommodation is nearly fully let to various tenants.<br><br>The total monthly rent received for the commercial accommodation as at 29 June 2007 was approximately HK$2,100,000 (including miscellaneous revenues receivable by the owner), exclusive of Government rates, management fees and other outgoings.<br><br>100% of the residential units and 60% of the car parking spaces are let.<br><br>The total monthly rent received for the residential units as at 29 June 2007 was approximately HK$480,000 (including the car parking spaces), exclusive of Government rates, management fees and other outgoings. | HK$532,000,000 |

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (39) | Commercial Accommodation, Kindergarten, 20 Residential Units and 20 Car Parking Spaces, Royal Ascot, No. 1 Tsun King Road, Shatin, New Territories<br><br>(cont'd) | The total gross floor area of the residential units is approximately 29,964ft$^2$ (2,783.72m$^2$). The unit individual size range from 1,128ft$^2$ (104.79m$^2$) to 1,623ft$^2$ (150.78m$^2$). They are all high-level units and the majority enjoys an open view over the racecourse.<br><br>Sha Tin Town Lot No. 411 is held from the Government under New Grant No. 12548 for a term from 8 December 1993 to 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | — | — |

*Notes:*

(1) The registered owner of the property is KCRC.

(2) The property comprises the following 20 residential units:

Block 1: Unit C on 32/F; Unit C on 35/F; Unit C on 37/F; Unit E on 33/F; Unit E on 36/F; Unit E on 37/F;

Block 2: Unit F on 33/F; Unit F on 36/F; Unit F on 37/F;

Block 3: Unit F on 33/F; Unit F on 36/F; Unit F on 38/F; Unit F on 41/F;

Block 6: Unit E on 33/F; Unit E on 35/F; Unit E on 38/F;

Block 7: Unit C on 35/F; Unit C on 38/F; Unit E on 36/F; Unit E on 38/F.

The property comprises the following 20 car parking spaces:

G/F: H021, G032, A016, H037, A021, C071, C073, H041, H149;

1/F: E198, D138, C022, C042, C044, B016, C046, B034, B038, D048, D113.

(3) The number of undivided shares is in accordance with a Deed of Reallocation of Shares executed in relation to the Commercial Accommodation.

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (40) | Commercial Accommodation (including the Reserved Commercial Areas) and Car Parking Space Nos. 1-10, 41-62 on Lower Part of the 1st Floor, Pierhead Garden, Nos. 168-236 Wu Chui Road, Tuen Mun, New Territories<br><br>5,362/32,942nd equal and undivided shares of and in Tuen Mun Town Lot No. 291 | Pierhead Garden comprises 6 blocks of 30-storey residential towers over a 2-storey podium for commercial, car parking and light rail terminus use. The development was completed in 1988.<br><br>The property comprises the commercial accommodation of Pierhead Garden together with 32 car parking spaces, erected over the Ferry Pier Light Rail Terminus. It is accessible from the ground level via four escalators.<br><br>According to the tenancy schedule provided to us, the gross floor area of the property (excluding the car parking spaces) is approximately 105,833ft$^2$ (9,832.13m$^2$).<br><br>Tuen Mun Town Lot No. 291 is held from the Government under the New Grant No. 2762 commencing from 2 April 1986 and expiring on 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The property is fully let to various tenants.<br><br>The total monthly rent received as at 29 June 2007 was approximately HK$4,100,000 (including car parking and miscellaneous revenues receivable by the owner), exclusive of Government rates, management fees and other outgoings. | HK$752,000,000 |

*Note:*

(1) The registered owner of the property is KCRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (41) | Commercial Accommodation (Comprising the Reserved Commercial Areas and the Kindergarten) and Portions of the Parking Areas, Sun Tuen Mun Centre, Nos. 55-65 Lung Mun Road, Tuen Mun, New Territories<br><br>1,653/41,800th equal and undivided shares of and in Tuen Mun Town Lot No. 289 (see note (2) below) | Sun Tuen Mun Centre comprises 10 blocks of 44-storey residential towers over a 3-storey podium for commercial, car parking and light rail depot use. The development was completed in 1990.<br><br>The property comprises the commercial areas and the kindergarten of Sun Tuen Mun Centre together with 421 private car parking spaces (see Note (2) below), erected over the Light Rail Depot.<br><br>According to the tenancy schedule provided to us, the gross floor area of the commercial areas (excluding the car parking spaces) is approximately 151,767ft$^2$ (14,099.50m$^2$), while the kindergarten has a gross floor area of approximately 20,000ft$^2$ (1,858.05m$^2$).<br><br>Tuen Mun Town Lot No. 289 is held from the Government under the New Grant No. 2770 commencing from 1 July 1898 for a term of 99 years which had been extended for a further term expiring on 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The property is let to various tenants. The occupancy rate of the retail space (excluding the vacant wet market) is approximately 85%.<br><br>The total monthly rent received as at 29 June 2007 was approximately HK$1,400,000 (including car parking and miscellaneous revenues receivable by the owner), exclusive of Government rates, management fees and other outgoings. | HK$259,000,000 |

*Notes:*

(1) The registered owner of the property is KCRC.

(2) According to the Land Registry record, there are 379 private car parking spaces in the development. However, according to the approved Addition and Alteration drawings, the number of car parking spaces is 421. The number of undivided shares as shown above is in accordance with the Land Registry record as at the date of valuation.

(3) During our on-site inspection, we noted that the property was undertaking some external renovation works. We are of the opinion that such works would not affect the rental values materially and have not taken into consideration the renovation works and the relevant costs.

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (42) | Reserved Commercial Areas and Car Parking Space Nos. G1-G19 on Ground Floor and P98-P100 on Lower Podium Level, Hanford Garden, No. 333 Castle Peak Road, Tuen Mun, New Territories<br><br>3,030/115,000th equal and undivided share of and in Tuen Mun Town Lot No. 359 | Hanford Garden comprises seven 27-storey residential towers over a 2-storey podium for commercial, car parking and light rail terminus use. The development was completed in 1993.<br><br>The property comprises the commercial areas of Hanford Garden together with 22 car parking spaces, erected over the Sam Shing Light Rail Terminus.<br><br>According to the tenancy schedule provided to us, the gross floor area of the property (excluding the car parking spaces) is approximately 34,766ft$^2$ (3,229.84m$^2$).<br><br>Tuen Mun Town Lot No. 359 is held from the Government under the New Grant No. 2972 commencing on 21 October 1991 and expiring on 30 June 2047. The annual Government rent payable for the property is 3% of its rateable value. | The property is nearly fully let.<br><br>The total monthly rent received as at 29 June 2007 was approximately HK$670,000 (including car parking spaces and miscellaneous revenues receivable by the owner), exclusive of Government rates, management fees and other outgoings. | HK$130,000,000 |

*Note:*

(1) The registered owner of the property is KCRC.

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (43) | Retail Floor, 1st to 6th Floors, Citylink Plaza, No. 1 Sha Tin Station Circuit, Sha Tin, New Territories | Citylink Plaza is a 11-storey commercial development erected above the Sha Tin KCRC Station, completed in 1983.<br><br>Based on the tenancy schedule and tenancy plans, the property comprises the Retail Floor (above the station concourse including the upper level of the Link Bridge) and 6 upper floors (1st to 6th Floors) for various commercial uses.<br><br>The Retail Floor is accessible by a pair of escalators from the station concourse and linked to L4 of the adjoining New Town Plaza. The 1st Floor comprises the "Foodlink' of the plaza accommodating various food and beverage, and is connected to the Retail Floor by a pair of escalators. Vertical movement between the upper floors from 1st Floor to 10th Floor is facilitated by 6 passenger lifts, 1 service lift and 3 staircases.<br><br>According to the tenancy schedule provided to us, the total gross floor area of the property is approximately 174,749ft$^2$ (16,234.58m$^2$). | The property is fully let.<br><br>The total monthly rent received as at 4 July 2007 was approximately HK$8,300,000 (including miscellaneous revenues from advertising and telecommunication facilities, etc), exclusive of Government rates, management fees and other outgoings. | HK$1,552,000,000 |

*Note:*

(1) The land was vested to KCRC under the KCR Ordinance for commercial purposes being shops and offices.

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (44) | Portion of Ground Floor and Portion of 1st Floor, KCRC Hung Hom Building, No. 8 Cheong Wan Road, Hung Hom, Kowloon | KCRC Hung Hom Building is a 2-storey commercial building erected above the Hung Hom KCRC Station. As quoted from Rating and Valuation Department, the building was completed in 1975.<br><br>The property comprises portions of the Ground Floor and 1st Floor with gross floor area of approximately 21,096ft$^2$ (1,959.87m$^2$). | The property is fully let to various tenants.<br><br>The total monthly rent received as at 29 June 2007 was approximately HK$380,000 (including miscellaneous revenues from telecommunication facilities etc), exclusive of Government rates, management fees and other outgoings. | HK$60,000,000 |

*Note:*

(1) The land was vested to KCRC under the KCR Ordinance for non-industrial (excluding residential) uses.

| | Property | Description, age and tenure | Particulars of occupancy | Investment Value as at 31 July 2007 |
|---|---|---|---|---|
| (45) | Staff Quarters, Trackside Villas, No. 4105 Tai Po Road, Tai Po, New Territories | The property comprises two 6-storey staff quarters buildings built over a carport, completed in 1991. A private club house with ancillary recreation facilities is built adjacent to the residential blocks for the sole use of the KCRC staff. As instructed, the club and recreation facilities are to be excluded from this valuation (as they are classified as staff club facilities).<br><br>According to the tenancy schedule provided to us, the property provides a total of 252 units, comprising a total gross floor area of approximately 120,312ft$^2$ (11,177.26m$^2$). The individual unit sizes range from approximately 420ft$^2$ (39.02m$^2$) to 736ft$^2$ (68.38m$^2$).<br><br>There are 72 car parking spaces within the development, with 60 of them designated as part of the property, whilst the remaining are reserved for Government use.<br><br>The land was vested to the KCRC in 1980s. Consent was later granted by the Government to use the site for staff quarters and ancillary recreational facilities at land premium of HK$1,000. | The property is let to various staff of the KCRC. 193 units of the total 252 units were let as at June 2007, representing an occupancy rate of about 79% by area.<br><br>The total monthly rent received in June 2007 was approximately HK$640,000 (including car parking spaces and miscellaneous revenues), inclusive of Government rates, management fees and other outgoings. | HK$69,000,000 |

*Notes:*

(1) The land was vested to KCRC.

(2) The property is subject to restriction against alienation. This assessment is made on the Investment Value basis and does not represent the market value of the property.

**Group 9 — Property Interests Held by KCRC for Development (Packages Awarded)**

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (46) | East Rail — Ho Tung Lau (Site A) Sha Tin, New Territories<br><br>Sha Tin Town Lot No. 470. | The property comprises a site with a registered site area of approximately 26,687m² (287,259ft²) adjoining East Rail Fo Tan Station. The proposed development at the property comprises composite commercial and residential uses. The total gross floor area of the proposed development is approximately 122,900m² (1,322,896ft²). | The property is under construction as at the date of valuation. | |

| Use | Gross Floor Area | | Parking Spaces |
|---|---|---|---|
| | ($m^2$) | ($ft^2$) | (nos.) |
| Residential | 120,900 | 1,301,368 | — |
| Retail | 2,000 | 21,528 | — |
| Carpark | — | — | 239 |
| **Total** | 122,900 | 1,322,896 | 239 |

According to the latest approved building plans, the residential development will comprise 10 tower blocks. Retail and recreational areas and 239 car parking spaces will also be provided at the proposed development, which will be built on top of a deck over the existing railway tracks.

Sha Tin Town Lot No. 470 is held from the Government under New Grant No. 13170 for a term of 50 years commencing on 3 March 2003. The annual Government rent payable for the lot is 3% of its rateable value.

Land premium of HK$1,322,000,000 for the lot was settled on 3 March 2003. The land premium of HK$71,370,000 was settled on 19 January 2006 for lease modification of the lot.

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (46) | East Rail — Ho Tung Lau (Site A) Sha Tin, New Territories<br><br>(cont'd) | — | — | — |

*Notes:*

(1) The registered owner of the property is KCRC.

(2) The development package in respect of the property has been awarded to a subsidiary of Sino Land Company Limited.

(3) The property is zoned "Other Specified Uses" annotated "(Railway Depot Comprehensive Development Area)" under the Sha Tin Outline Zoning Plan No. S/ST/23 dated 15 June 2007.

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (47) | Ma On Shan Rail — Wu Kai Sha Sha Tin, New Territories<br><br>Sha Tin Town Lot No. 530 | The property comprises a site with an area of approximately 34,151m$^2$ (367,601ft$^2$) at the junction of Sai Sha Road and Sha On Street in the Sha Tin district. The proposed development at the Property comprises composite commercial and residential uses on top of the Ma On Shan Rail Wu Kai Sha Station and a covered public transport interchange. The total gross floor area of the proposed development is approximately 172,650m$^2$ (1,858,405ft$^2$). | The property is under construction as at the date of valuation. | |

| Use | Gross Floor Area | | Parking Spaces |
|---|---|---|---|
| | *(m$^2$)* | *(ft$^2$)* | *(nos.)* |
| Residential | | | |
| Phase 1 | 66,985 | 721,027 | — |
| Phase 2 | 52,465 | 564,733 | — |
| Phase 3 | 49,200 | 529,589 | — |
| Kindergarten | 1,000 | 10,764 | — |
| Retail | 3,000 | 32,292 | — |
| Carpark | — | — | 305 |
| **Total** | 172,650 | 1,858,405 | 305 |

According to the land grant, the proposed development will be divided into Site A, Site B and Site C and developed in three phases. According to the latest approved building plans, Phase 1 will comprise three residential tower blocks and the podium including the ancillary car parking as well as park and ride facility, kindergarten, retail and recreational facilities.

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (47) | Ma On Shan Rail — Wu Kai Sha Sha Tin, New Territories<br><br>(cont'd) | Phase 2 will comprise two residential tower blocks atop the podium. Phase 3 will comprise two residential tower blocks.<br><br>Sha Tin Town Lot No. 530 is held from the Government under New Grant No. 20139 for a term of 50 years commencing from 6 October 2005. The annual Government rent payable for the lot is 3% of its rateable value.<br><br>Land premium for the various sites within the property was settled as shown below:<br><br>Site A : HK$2,003,680,000<br>Site B : HK$1,747,760,000<br>Site C : HK$1,639,750,000 | — | — |

*Notes:*

(1) The registered owner of the property is KCRC.

(2) The development package in respect of the property has been awarded to a subsidiary of Sino Land Company Limited.

(3) The property is zoned "Other Specified Uses" annotated "Railway Station and Public Transport Interchange with Commercial/Residential Development" under the Ma On Shan Outline Zoning Plan No. S/MOS/13 dated 5 October 2004.

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (48) | Ma On Shan Rail — Tai Wai Maintenance Centre Sha Tin, New Territories<br><br>Sha Tin Town Lot No. 529 | The property comprises an elongated site with a site area of approximately 70,597m² (759,906ft²) at the junction of Mei Tin Road and Che Kung Miu Road on the southwestern side of KCR Tai Wai Station. The proposed development at the property is a residential development comprising twelve blocks atop Tai Wai Maintenance Centre. The development will be linked to Tai Wai Station via pedestrian footbridges.<br><br>The total gross floor area of the proposed development is approximately 313,955m² (3,379,411ft²). | The bottom part of the property is currently occupied by Tai Wai Maintenance Centre. | |

| Use | Gross Floor Area (m²) | (ft²) | Parking Spaces (nos.) |
|---|---|---|---|
| Residential | | | |
| Site B | 100,372 | 1,080,404 | — |
| Site C | 113,211 | 1,218,603 | — |
| Site D | 100,372 | 1,080,404 | — |
| Carpark | — | — | 715 |
| **Total** | 313,955 | 3,379,411 | 715 |

According to the land grant, the proposed development will be developed in three phases.

Sha Tin Town Lot No. 529 is held from the Government under New Grant No. 20227 for a term of 50 years commencing on 21 December 2004. The annual Government rent payable for the lot is 3% of its rateable value.

Land premium for the various sites within the property was settled as shown below:

Sites B & D : HK$7,200,160,000
Site C : HK$4,359,700,000

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (48) | Ma On Shan Rail — Tai Wai Maintenance Centre Sha Tin, New Territories<br><br>(cont'd) | — | — | — |

*Notes:*

(1) The registered owner of the property is KCRC.

(2) The development package in respect of the property has been awarded to a subsidiary of Cheung Kong (Holdings) Limited.

(3) The property is zoned "Other Specified Uses" annotated "(Railway Depot Comprehensive Development Area)" under the Sha Tin Outline Zoning Plan No. S/ST/23 dated 15 June 2007.

**Total for Property 46 to Property 48: HK$5,166,000,000****

** KCRC's share of development profits for all property interest held for development (packages awarded) is in the range of 31% to 93%.

**Group 10 — Property Interests Held by KCRC for Development (Packages to be Awarded)**

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (49) | Ma On Shan Rail — Che Kung Temple Sha Tin, New Territories | The property comprises a site with area of approximately 18,136m² (195,216ft²) at the Ma On Shan Rail Che Kung Temple Station to the north of Chun Shek Estate in Sha Tin.<br><br>The proposed development at the property will be built on top of Che Kung Temple Station and the adjoining land on its north. According to the approved master layout plan, the proposed development will comprise four 38 to 40-storey residential blocks, a kindergarten and ancillary retail and recreational facilities. The total gross floor area of the proposed development is approximately 90,655m² (975,810ft²). | The bottom part of the property is currently occupied by KCRC for the operation of Che Kung Temple Station. Part of the property is occupied as open public car park. | |

| Use | Gross Floor Area | | Parking Spaces |
|---|---|---|---|
| | *(m²)* | *(ft²)* | *(nos.)* |
| Residential | 89,792 | 966,521 | — |
| Retail | 193 | 2,077 | — |
| Kindergarten | 670 | 7,212 | — |
| Carpark | — | — | 236 |
| **Total** | 90,655 | 975,810 | 236 |

Relevant land grant from the Government is to be obtained for this development site.

*Notes:*

(1) The development package in respect of the property has not been awarded.

(2) The property is zoned "Comprehensive Development Area (1)" under the Sha Tin Outline Zoning Plan No. S/ST/23 dated 15 June 2007.

(3) A planning approval for comprehensive residential development has been obtained from the Town Planning Board in respect of the property on 12 January 2007. The planning permission shall cease to have effect on 31 May 2010 unless prior to the said date either the development permitted is commenced or the permission is renewed.

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (50) | Ma On Sha Rail — Tai Wai Station Sha Tin, New Territories | The property comprises a site with area of approximately 48,500m$^2$ (522,054ft$^2$) at Tai Wai Station at the junction of Mei Tin Road and Che Kung Miu Road. The proposed development at the property is a composite commercial and residential development comprising eight residential blocks atop Tai Wai Station, the adjoining covered public transport interchange and a commercial and recreational podium. The development will be linked to the proposed development at Tai Wai Maintenance Centre via pedestrian footbridges. | The bottom part of the property is currently occupied by Tai Wai Station and a covered public transport interchange, which have been in operation. | |

The floor area breakdown of the proposed development is as follows:

| Use | Gross Floor Area | | Parking Spaces |
|---|---|---|---|
| | *(m$^2$)* | *(ft$^2$)* | *(nos.)* |
| Retail - Phase 1 | 62,000 | 667,368 | — |
| Residential | | | |
| Phase 1 | 63,859 | 687,378 | — |
| Phase 2 | 74,683 | 803,888 | — |
| Phase 3 | 51,938 | 559,061 | — |
| Kindergarten | 1,110 | 11,948 | — |
| Carpark | — | — | 713 |
| Total | 253,590 | 2,729,643 | 713 |

The total gross floor area of the proposed development is approximately 253,590m$^2$ (2,729,643ft$^2$).

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (50) | Ma On Sha Rail — Tai Wai Station Sha Tin, New Territories<br><br>(cont'd) | According to approved master layout plan and draft land grant terms, the proposed development will be developed in three phases. Phase 1 will comprise the commercial podium and various residential towers. Phase 2 and 3 will comprise residential towers. Ancillary car parking spaces will be provided at each phase.<br><br>Relevant land grant from the Government is to be obtained for this development site. | — | — |

*Notes:*

(1) The development package in respect of the property has not been awarded.

(2) The property is zoned "Comprehensive Development Area (1)" under the Sha Tin Outline Zoning Plan No. S/ST/23 dated 15 June 2007. A planning approval for comprehensive commercial and residential development has been obtained from the Town Planning Board in respect of the property on 29 July 2005. The planning permission should cease to have effect on 29 July 2009 unless prior to the said date either the development permitted was commenced or the permission was renewed.

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (51) | Light Rail — Tin Shui Wai Terminus Yuen Long, New Territories | The property comprises a roughly rectangular site with an area of approximately 18,232m$^2$ (196,249ft$^2$) at the junction of Tin Shui Road and Tin Sau Road close to Tin Yat Estate in Tin Shui Wai. | The bottom part of the property is currently partly occupied as the Light Rail Tin Shui Wai Terminus and an open public transport terminus. | |

According to the approved master layout plan, the proposed development at the property will be built above the Light Rail and public transport terminus. The proposed development will comprise four residential blocks. The total gross floor area of the proposed development is approximately 91,256m$^2$ (982,280ft$^2$).

| Use | Gross Floor Area | | Parking Spaces |
|---|---|---|---|
| | *(m$^2$)* | *(ft$^2$)* | *(nos.)* |
| Residential | 91,051 | 980,073 | — |
| Retail | 205 | 2,207 | — |
| Carpark | — | — | 267 |
| **Total** | 91,256 | 982,280 | 267 |

Relevant land grant from the Government is to be obtained for this development site.

*Notes:*

(1) The development package in respect of the property has not been awarded.

(2) The property is zoned "Other Specified Uses" annotated "(LRT Terminus)" under the Tin Shui Wai Outline Zoning Plan No. S/TSW/10 dated 8 November 2005.

(3) The Town Planning Board approved a planning permission for a master layout plan for residential / retail development on 17 November 2001. The Town Planning Board on 8 October 2004 approved the extension of the validity period of the planning permission for 3 years until 17 November 2007.

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (52) | Kowloon Southern Link — Sites C and D, Tsim Sha Tsui, Kowloon | The property comprises two development sites at the proposed West Kowloon Station of the Kowloon Southern Link. | Construction of the Kowloon Southern Link is undergoing at the property. | |

Site C comprises a site area of approximately 8,145m$^2$ (87,673ft$^2$) and is located close to the junction of Jordan Road and Canton Road to the east of the MTR Kowloon Station. The proposed West Kowloon Cultural District is located to the southern side of Site C.

According to the information provided to us, residential flats and ancillary commercial space will be provided at the proposed development on Site C. The total gross floor area of the proposed development is approximately 48,870m$^2$ (526,037ft$^2$).

| **Use** | **Gross Floor Area** | | **Parking Spaces** |
|---|---|---|---|
| | *(m$^2$)* | *(ft$^2$)* | *(nos.)* |
| Residential | 40,725 | 438,364 | — |
| Retail | 8,145 | 87,673 | — |
| Carpark | — | — | 125 |
| **Total** | 48,870 | 526,037 | 125 |

Site D comprises a site area of approximately 12,814m$^2$ (137,930ft$^2$) and is located close to the junction of Jordan Road and Canton Road to the east of the MTR Kowloon Station. The proposed West Kowloon Cultural District is located to the southern site of Site D.

| | Property | Description and tenure | Particulars of occupancy | Market value of the property interest attributable to KCRC as at 31 July 2007 |
|---|---|---|---|---|
| (52) | Kowloon Southern Link — Sites C and D Tsim Sha Tsui, Kowloon<br><br>(cont'd) | According to the information provided to us, residential flats and ancillary commercial space will be provided at the proposed development on Site D. The total gross floor area of the proposed development is approximately 76,884m$^2$ (827,579ft$^2$). | — | — |

| Use | Gross Floor Area (m$^2$) | Gross Floor Area (ft$^2$) | Parking Spaces (nos.) |
|---|---|---|---|
| Residential | 64,070 | 689,649 | — |
| Retail | 12,814 | 137,930 | — |
| Carpark | — | — | 196 |
| **Total** | 76,884 | 827,579 | 196 |

Relevant land grant from the Government is to be obtained for these two development sites.

*Notes:*

(1) The development package in respect of the property has not been awarded.

(2) The property is zoned "Residential (Group A)2" and road under the South West Kowloon Outline Zoning Plan No. S/K20/19 dated 18 May 2007.

(3) For the purpose of valuation, we have assumed that the zoning of the property would accommodate or permit the proposed development. It is also assumed that relevant consents or approvals for the proposed development would be granted.

**Total for Property 49 to Property 52: HK$2,054,000,000****

** KCRC's share of development profits for all property interest held for future development is assumed to be in the range of 30% to 50%.

**Group 11 — Other Property Interests of KCRC**

| | Property | Description, age and tenure | Particulars of occupancy | Market Value as at 31 July 2007 |
|---|---|---|---|---|
| (53) | 2 Leased Properties in Hong Kong and 2 Leased Properties in the PRC | The properties comprise the following:<br>• 2 leased office premises in Hong Kong with an approximate gross floor area of 102,631ft$^2$ (9,534.6m$^2$), held for respective terms of 3 years and approximately 3 years and 11 months.<br>• 2 leased office premises in the PRC with approximate gross floor area of 1,856ft$^2$ (172.4m$^2$), both held for terms of 1 year. | The properties are currently occupied by KCRC as offices. | No commercial value |

## 1. RESPONSIBILITY STATEMENT

This Circular includes particulars given in compliance with the Listing Rules for the purpose of giving information with regard to the Company. The Directors collectively and individually accept full responsibility for the accuracy of the information contained in this Circular and confirm, having made all reasonable enquiries, that to the best of their knowledge and belief there are no other facts the omission of which would make any statement herein misleading.

## 2. DIRECTORS SERVICE CONTRACTS AND LETTERS OF APPOINTMENT

At the Latest Practicable Date, none of the Directors had entered into any service contracts with the Company or any other member of the Group (excluding contracts expiring or determinable by the employer within one year without payment of compensation other than statutory compensation).

## 3. DIRECTORS' COMPETING INTERESTS, INTERESTS IN MATERIAL CONTRACTS AND INTERESTS

Except as otherwise disclosed in this Circular, no contracts of significance to which the Company or any member of its Group was a party and in which a Director had a material interest and which was significant to the Company business, whether directly or indirectly, subsisted at the Latest Practicable Date. Except as otherwise disclosed in this Circular, none of the Directors or any proposed Directors or their respective associates has any competing interest (as would be required to be disclosed under Rule 8.10 of the Listing Rules if each of them were a controlling shareholder of the Company for the purpose of the Listing Rules) or any interest, direct or indirect, in any of the assets which are the subject of the Rail Merger.

## 4. DETAILS OF DIRECTORS AND SENIOR MANAGERS

With effect from the Merger Date, the members of the Board, the Executive Directorate and deputy Directors will be as set out below. Government may also, at its sole discretion, determine before the Merger Date the number of additional non-executive Directors (if any) to be appointed to the Board on the Merger Date. The senior managers of the Company will be appointed after the date of the Merger EGM.

### Members of the Board

**Dr. Raymond Ch'ien Kuo-fung** 55, was appointed Non-Executive Chairman in July 2003. He has been a member of the Board since 1998. Dr. Ch'ien is chairman of CDC Corporation and its subsidiary, China.com Inc. He is also non-executive chairman of HSBC Private Equity (Asia) Limited, as well as chairman and independent non-executive director of Hang Seng Bank Limited. He serves on the boards of The Hongkong and Shanghai Banking Corporation Limited, Inchcape plc, Convenience Retail Asia Limited, VTech Holdings Limited and The Wharf (Holdings) Limited. Dr. Ch'ien is chairman of the Hong Kong/European Union Business Cooperation Committee and a Hong Kong member of the APEC Business Advisory Council. In addition, Dr. Ch'ien is the honorary president and past chairman of the Federation of Hong Kong Industries. He was a member of the Executive Council of Hong Kong, then under British Administration, from 1992 to 1997, a member of the Executive Council of the Hong Kong SAR from 1 July 1997 to June 2002 and chairman of the Advisory Committee on Corruption of the Independent Commission Against Corruption from 1 January 1998 to 31 December 2006. Dr. Ch'ien was appointed a Justice of the Peace in 1993. He was made a Commander in the Most Excellent Order of the British Empire in 1994 and awarded the Gold Bauhinia Star medal in 1999. Dr. Ch'ien received a doctoral degree in economics from the University of Pennsylvania in 1978 and became a Trustee of the University in 2006.

**Chow Chung-kong** 56, was appointed Chief Executive Officer on 1 December 2003. He was formerly chief executive officer of Brambles Industries Ltd, a global support services company. From 1997 to 2001, Mr. Chow was chief executive of GKN PLC, a leading engineering company based in the United Kingdom and before that, he spent 20 years with the BOC Group PLC and was appointed a director of its board and chief executive of its Gases Division in 1993. Mr. Chow is a chartered engineer. He holds Bachelor of Science and Master of Science degrees in Chemical

Engineering from The University of Wisconsin and The University of California respectively. He also holds a Master of Business Administration degree from The Chinese University of Hong Kong and was a graduate of the Advanced Management Program of Harvard Business School. He was awarded an Honorary Doctor of Engineering degree by The University of Bath. Mr. Chow was knighted in the United Kingdom in 2000 for his contribution to industry. He is currently a member of the Council of the Hong Kong Institute of Certified Public Accountants, the Hong Kong Tourism Board and the Council of The Chinese University of Hong Kong. He is also a member of the general committee of the Hong Kong General Chamber of Commerce, a member of both the Commission on Strategic Development and the Standing Committee on Directorate Salaries and Conditions of Service of the HKSAR Government, and a member of the Standing Committee of the Shenzhen Municipal Committee of the Chinese People's Political Consultative Conference. Mr. Chow is a non-executive director of Standard Chartered PLC and the non-executive chairman of Standard Chartered Bank (Hong Kong) Limited.

**Professor Cheung Yau-kai** 72, is an independent non-executive Director and has been a member of the Board since 1999. Professor Cheung is Honorary Professor of Engineering and Special Adviser to the Vice-Chancellor of The University of Hong Kong. He was Taikoo Professor of Engineering and Acting Deputy Vice-Chancellor of The University of Hong Kong until 30 June 2000. Professor Cheung began his academic research career at the University College of Swansea, Wales. He was appointed Professor of Civil Engineering at Calgary in 1970 and moved to the University of Adelaide in 1974 as Professor and Chairman of the Department of Civil Engineering. In 1977, he took up the Chair and Headship of the Department of Civil Engineering in The University of Hong Kong. In addition to his academic appointments, Professor Cheung was the former first Senior Vice-President of the Hong Kong Institution of Engineers and the Ex-Chairman of its Accreditation Board. He has been awarded several honorary degrees at educational institutions, including, an honorary Doctor of Science by The University of Hong Kong and an honorary Doctor of Laws by the University of Wales. He has also been elected a member of the Chinese Academy of Sciences, and is a fellow of the Royal Academy of Engineering, a fellow of the Royal Society of Canada and immediate past President of the Hong Kong Academy of Engineering Sciences.

**David Gordon Eldon** 61, is an independent non-executive Director and has been a member of the Board since 1999. He retired from the HSBC Group in May 2005 after 37 years of service. He was Chairman of The Hongkong and Shanghai Banking Corporation Limited from January 1999 to May 2005, non-executive Chairman of Hang Seng Bank Limited from June 1996 to April 2005, and a board member of Swire Pacific Limited until May 2005. Mr. Eldon was the Executive Committee Chairman of The Community Chest of Hong Kong until June 2005 and is currently its Vice Patron. He is senior adviser to PricewaterhouseCoopers (based in Hong Kong), Chairman of the Dubai International Financial Centre Authority, the Noble Group Limited, and Diocesan Girls' School Education Foundation Limited. He is Deputy Chairman of the Hong Kong Jockey Club, a member of the Advisory Board of Unisys and an independent non-executive director of Eagle Asset Management (CP) Limited and China Central Properties Limited. Mr. Eldon was appointed a member of the Capital Adequacy Review Tribunal in 2007 and holds a number of other community service appointments. Mr. Eldon is a fellow of the Chartered Institute of Bankers and a fellow of the Hong Kong Institute of Bankers. He is a Justice of the Peace.

**Christine Fang Meng-sang** 48, is an independent non-executive Director and has been a member of the Board since 2004. Ms. Fang has been the chief executive of the Hong Kong Council of Social Service since 2001. Prior to joining the Hong Kong Council of Social Service, she worked for the Hong Kong Red Cross from 1989 to 2001 and held the position of Secretary General from 1993 to 2001. By training, Ms. Fang is a social worker and has a strong background in community service. She sits on various government advisory committees, including the Social Welfare Advisory Committee, the Manpower Development Committee, the Sustainable Development Council and the Digital 21 Strategy Advisory Committee. She is also a member of the Commission on Strategic Development.

**Edward Ho Sing-tin** 68, is an independent non-executive Director and has been a member of the Board since 1991. He is an architect and the deputy chairman and managing director of Wong Tung & Partners Limited. Mr. Ho was an elected member of the Legislative Council of Hong Kong from 1991 to 2000, representing the architectural, surveying and planning functional constituency. He was president of the Hong Kong Institute of Architects in 1983 and 1984 and was chairman of the Hong Kong Industrial Estates Corporation from 1992 to 2001. Mr. Ho serves on a number of statutory boards and advisory committees including the Board of Hong Kong Hospital Authority. He is also chairman of the Board of Governors of the Hong Kong Philharmonic Society Ltd. and chairman of the Antiquities Advisory Board.

**Lo Chung-hing** 55, is an independent non-executive Director and has been a member of the Board since 1995. He is general manager of Bank of China (Hong Kong) Limited, after the restructuring of the Bank of China Group in October 2001. Mr. Lo began his banking career in 1969 and he served in several positions within the Bank of China Group before being appointed to his present post. He is a director of the Urban Renewal Authority. Mr. Lo was appointed as a board member of the Provisional Airport Authority in 1994 and served as vice chairman of the Airport Authority from April 1996 to May 1999. He was also a board member of the Hospital Authority from December 1997 to November 2005. Mr. Lo was awarded the Silver Bauhinia Star medal in 1998.

**T. Brian Stevenson** 62, is an independent non-executive Director and has been a member of the Board since October 2002. He is a non-executive director of The Hongkong and Shanghai Banking Corporation Limited, a member of the Asia Pacific Advisory Board of BT, a member of the Public Service Commission and a Steward of the Hong Kong Jockey Club. Mr. Stevenson was previously the Senior Partner of Ernst & Young, Hong Kong from 1981 to 1999. He served on the Council of the Hong Kong Society of Accountants from 1991 to 1997 and was president of the Society in 1996. Mr. Stevenson is a chartered accountant and holds law degrees from Glasgow and Hong Kong Universities. He was awarded the Silver Bauhinia Star medal in 1998. He is also a Justice of the Peace.

**Secretary for Transport and Housing** (Eva Cheng 47, joined the Board as a non-executive Director appointed as an "additional director" under section 8 of the MTR Ordinance on 1 July 2007 upon her appointment as the Secretary for Transport and Housing of the Government of the Hong Kong SAR. Ms. Cheng has served in various bureaux and departments of the Government of the HKSAR since 1983. Before joining the Transport and Housing Bureau, Ms. Cheng was the Permanent Secretary for Economic Development and Labour (Economic Development). She is a graduate of the University of Hong Kong and holds a Bachelor of Social Science degree.)

**Professor K C Chan,** 50, joined the Board as a non-executive Director on 10 July 2007 after his appointment as the Secretary for Financial Services and the Treasury of the Government of the Hong Kong SAR with effect from 1 July 2007. He received his bachelor's degree in economics from Wesleyan University in the US and both his M.B.A. and Ph.D. in finance from the University of Chicago. Professor Chan sits on the boards of several public bodies including the Mandatory Provident Fund Schemes Authority and The Hong Kong Mortgage Corporation Limited in his official capacity. Before joining the Government, Professor Chan was Dean of Business and Management of the Hong Kong University of Science and Technology from 1 July 2002. He was also an independent non-executive Director of Shui On Construction and Materials Limited from 1 June 2005 to 30 June 2007.

**Commissioner for Transport** (Alan Wong Chi-kong 52, joined the Board as a non-executive Director appointed as an "additional director" under section 8 of the MTR Ordinance by virtue of his appointment to the post of the Commissioner for Transport of the Government of the Hong Kong SAR on 18 June 2005. Prior to that, Mr. Wong has served in various bureaux and departments of the Government of the Hong Kong SAR including the Home Affairs Bureau, Civil Service Bureau, the former Urban Services Department, the former City and New Territories Administration, the former Health and Welfare Branch, the former Recreation and Culture Branch, the former Secretariat of the University and Polytechnic Grants Committee, the former Trade and Industry Branch, the Office of the Commissioner of Insurance from August 1996 to January 2000, the Mandatory Provident Fund Schemes Authority from January 2000 to June 2001, the former Information Technology Services Department from July 2001 to July 2004, and the Office of the Government Chief Information Officer from July 2004 to January 2005. As

Commissioner for Transport, Mr. Wong is also a director of several transport-related companies, including The Kowloon Motor Bus Company (1933) Limited, Long Win Bus Company Limited, New World First Bus Services Limited, New Lantao Bus Company (1973) Limited, Citybus Limited, The Star Ferry Company Limited, The New Hong Kong Tunnel Company Limited, Western Harbour Tunnel Company Limited, Tate's Cairn Tunnel Company Limited and Route 3 (CPS) Company Limited.)

**Members of the Executive Directorate**

**Chow Chung-kong** Biographical details are set out in section 4 of this Appendix under the paragraph headed "Members of the Board".

**Russell John Black** 60, has been the Project Director of the Company since 1992. He is responsible for the planning and implementation of all major railway extension and upgrade projects, which have included the Airport Railway project, the Quarry Bay Congestion Relief Works, the Tseung Kwan O Extension project, the Disneyland Resort Line and the Tung Chung Cable Car. He is also responsible for undertaking feasibility studies into possible new extensions to the railway, including the South Island Line and the West Island Line and providing project management expertise to railway projects in Mainland of China. Mr. Black initially worked for the Company from 1976 to 1984 and, prior to rejoining the Company in 1992, he was the project director of London Underground's Jubilee Line Extension project from 1990 to 1992 and, before that, he worked on Singapore's underground railway and on the Eastern Harbour Crossing. Mr. Black served on the Vocational Training Council from 1998 to 2002, the Construction Advisory Board from 1993 to 1999, the Provisional Construction Industry Coordination Board from 2001 to January 2007 and has been appointed as a member of the Construction Industry Council from 1 February 2007. Mr. Black holds an honours degree in civil engineering from the University of Canterbury in New Zealand. In 2006, he was elected an International Fellow of The Royal Academy of Engineering. He is also a Fellow of the Hong Kong Academy of Engineering Sciences, the Hong Kong Institution of Engineers and the Institution of Professional Engineers, New Zealand. He was awarded the Public Service medal (PBM) in Singapore in 1986 and the Bronze Bauhinia Star medal in 1999.

**William Chan Fu-keung** 58, has been the Human Resources Director since August 1998. He joined the Company as Human Resources Manager in 1989. He is responsible for human resource management, people development, operations and management training, administration and security management. Prior to joining the Company, Mr. Chan held senior managerial positions both in the commerce and in the utility sectors in Hong Kong, including the Government, the Hong Kong Productivity Council, Hutchison Whampoa Limited and Hong Kong Telecommunications Limited. He is a fellow member of the Hong Kong Institute of Human Resource Management since 1985 and is also the Vice President of the Institute. He is a Council member of Employers' Federation of Hong Kong, and a member of the Remuneration Committee of the Hong Kong Housing Society, and the Career Development and Advisory Board for a number of universities. Mr. Chan received a Bachelor of Social Science degree from The University of Hong Kong in 1971, majoring in economics.

**Thomas Ho Hang-kwong** 56, has served as the Property Director since joining the Company in 1991. He is responsible for the development and management of all properties above and adjacent to MTR stations and depots. He leads a multi-disciplinary team of managers involved in the planning, design, construction and management of large-scale property developments. Between 1971 and 1990, Mr. Ho worked for the Hong Kong Government specialising in land administration and latterly held a directorate post in the Lands Department, responsible for formulating policies and procedures to make land available for the airport and the Airport Railway project. Mr. Ho was qualified in 1974 as a chartered surveyor in Hong Kong. He is serving The Community Chest of Hong Kong as a Member of the Campaign Organising Committee and a Co-Chairman of the Corporate and Employee Contribution Programme.

**Lincoln Leong Kwok-kuen** 46, has served as the Finance Director since February 2002. He is responsible for the financial management of all of the Company's affairs, including financial planning and control, budgeting, accounting and reporting and the treasury function. In addition, he has responsibility for the Company's information technology function and serves as chairman of both Octopus Holdings Limited and the board of trustees of the Company's retirement scheme. Mr. Leong graduated from Cambridge University in 1982 and later qualified as a chartered accountant in England in 1985 and Canada in 1986. Prior to joining the Company as Finance Director, he worked in both the accountancy and investment banking industries. Mr. Leong has also worked as an accountant in London and Vancouver, Canada and for a number of years as an investment banker in Hong Kong. Mr. Leong is the chairman of the executive committee of the Hong Kong Society for the Protection of Children, a member of the supervisory board of the Hong Kong Housing Society and a board member of the Community Chest. He also serves on the Board of Governors of the Chinese International School and is a trustee of the Hospital Authority Pension Fund Scheme. Mr. Leong is also a non-executive director of both Hong Kong Aircraft Engineering Company Limited and Tai Ping Carpets International Limited.

**Francois Lung Ka-kui** 48, has served as the China & International Business Director since September 2005. He heads the Company's growth-business efforts, including investments in Mainland of China, operating franchises in Europe and international consultancy. Dr. Lung has held various positions in a number of Royal Dutch Shell affiliates since 1997 and joined the Company from Shell Eastern Petroleum (Pte) Ltd. He was the General Manager, China, with responsibility for strategy development, governance and business performance of Shell's gas and power business in China. From 1994 to 1997, he held positions at Duke Energy Asia Limited, an affiliate of Duke Energy International, becoming Vice-President in 1996. Prior to this, Dr. Lung spent approximately five years at PowerGen plc, a major generator, distributor and retailer of electricity in the United Kingdom, and three years at the Central Electricity Generating Board before the privatisation of the electricity industry in the United Kingdom. Dr. Lung holds a Bachelor of Science degree in Mechanical Engineering from the University of Hong Kong, a PhD in Combustion from the University of Leeds in the United Kingdom, a Master of Science degree in Management from the University of Southampton in the United Kingdom and a Bachelor of Law degree from the University of London. Dr. Lung was admitted to the Bar of the United Kingdom in 1992.

**Andrew McCusker** 62, has served as the Operations Director since December 2005. Mr. McCusker has more than 40 years of experience in the operating, engineering and projects fields in Defence, Power, Water and Rail Industries. He joined the Company as Operations Engineering Manager in 1987, and since then has been posted to other responsible positions, including Operations Engineering Design Manager, Project Manager (Operations) and General Manager (Operations). He was appointed Deputy Operations Director in March 2004 and Acting Operations Director in October 2005. Mr. McCusker holds a degree in Mechanical Engineering from the Kensington University in the United States and is a chartered member of both the Institution of Mechanical Engineers of the United Kingdom and the Chartered Institute of Personnel and Development (U.K.).

**Leonard Bryan Turk** 57, is a solicitor admitted to practise both in England and Wales and in Hong Kong. He joined the Company in 1981 and has been Legal Director and Secretary to the Board since 1988. Mr. Turk is responsible for legal advice, corporate secretarial services, insurance, procurement and enterprise risk management functions within the Company. His responsibilities also include matters of corporate governance as well as construction contracts, contract administration and dispute resolution. Before joining the Company, Mr. Turk worked in England, concentrating particularly on commercial property development and the financing of large projects.

**Deputy Directors**

**Dr. Lee Kang-kuen** 59, has been appointed as Deputy Project Director for the Company with effect from the Merger Date. Dr. Lee joined KCRC in 1981, prior to its corporatisation. He was appointed as director of East Rail in 1997, director of East Rail Extensions in 1998 and was appointed Senior Director-Capital Projects in 2004. Dr. Lee is an Adjunct Professor in Electrical Engineering and University Fellow, Hong Kong Polytechnic University and a Member of Advisory Committee, Community College of Hong Kong Polytechnic University.

**Li Yun-tai** 55, has been appointed as Deputy Operations Director for the Company with effect from the Merger Date. Mr. Li was previously employed by the Company from 1978 to 1984 and joined KCRC in 1984. He was appointed as Senior Director - Transport for KCRC in 2003. Mr. Li currently holds the position of Vice Chairman of Asia-Pacific Division, International Association of Public Transport (UITP). He is also a Council Member of the

Chartered Institute of Logistics & Transport in Hong Kong and a Member of the Steering Committee on Principals' Professional Development, Users' Committee of the Immigration Department and the Transport & Logistics Services Council of the Federation of Hong Kong Industries.

**David Fleming** 61, has been appointed as Deputy Legal Director for the Company with effect from the Merger Date. Mr. Fleming is a solicitor admitted to practise in Hong Kong, England and Wales, and Australia. In 1993 he was engaged as KCRC's principal legal adviser. In 1997 he was appointed as Company Secretary and General Counsel. Before joining KCRC, Mr. Fleming worked as a solicitor in private practice in Hong Kong and Australia, and in the legal department of the Government.

## 5. DIRECTORS' INTERESTS IN THE GROUP

At the Latest Practicable Date, the interests or short positions of each Director in the shares, underlying shares and debentures of the Company (within the meaning of Part XV of the SFO), and the details of any right to subscribe for shares in the Company, as required to be notified to the Company and the Stock Exchange pursuant to Divisions 7 and 8 of the Part XV of the SFO (including interests and short positions, if any, which they were taken or deemed to have under such provisions of the SFO), as required to be entered in the register kept by the Company referred to under section 352 of the SFO or as otherwise required to be notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Issuers contained in the Listing Rules, were as follows:

| | Number of Ordinary Shares held | | | Derivatives | | | |
|---|---|---|---|---|---|---|---|
| | | | | Share Options | Other | | Percentage of aggregate interests to total issued share capital |
| **Name of Director** | **Personal* interests** | **Family+ interests** | **Corporate interests** | **Personal* interests** | **Personal* interests** | **Total interests** | |
| Raymond Ch'ien Kuo-fung | 10,000 | — | — | — | — | 10,000 | 0.00018 |
| Chow Chung-kong | — | — | — | — | 418,017 *(Note 1)* | 418,017 | 0.00748 |
| T. Brian Stevenson | 4,755 | — | — | — | — | 4,755 | 0.00009 |
| Christine Fang Meng-sang | 1,712 | — | — | — | — | 1,712 | 0.00003 |
| Russell John Black | 54,748 | — | — | — | — | 54,748 | 0.00098 |
| William Chan Fu-keung | 46,960 | — | — | 217,500 *(Note 2)* | — | 264,460 | 0.00473 |
| Thomas Ho Hang-kwong | 54,640 | 2,541 | — | 321,000 *(Note 2)* | — | 378,181 | 0.00677 |
| Lincoln Leong Kwok-kuen | 23,000 | — | 23,000 *(Note 3)* | 1,043,000 *(Note 4)* | 160,000 *(Note 5)* | 1,249,000 | 0.02235 |
| Francois Lung Ka-kui | 46,000 | 2,500 | — | 1,066,000 *(Note 4)* | — | 1,114,500 | 0.01994 |
| Ho Suen-wai *(Note 6)* | 677 | 1,361 | — | — | — | 2,038 | 0.00004 |

*Notes:*

1. Chow Chung-kong has a derivative interest in respect of 418,017 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 418,017 shares in the Company on completion of his three-year contract (on 30 November 2009).

2. 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.

3. The 23,000 shares are held by Linsan Investment Ltd., a private limited company beneficially wholly owned by Lincoln Leong Kwok-kuen.

4. 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.

5. Lincoln Leong Kwok-kuen has a derivative interest in respect of 160,000 shares in the Company within the meaning of Part XV of the SFO. That derivative interest represents Mr. Leong's entitlement to receive an equivalent value in cash of 160,000 shares in the Company on 9 April 2010.

6. The office of the Permanent Secretary for Transport and Housing (Transport) is an Alternate Director to the office of the Secretary for Transport and Housing (Eva Cheng). The Secretary for Transport and Housing is a non-executive Director of the Company. Mr. Ho Suen-wai is the holder of the post of the Permanent Secretary for Transport and Housing (Transport).

7. On 23 August 2007, Dr. Raymond Ch'ien Kuo-fung purchased 40,000 MTRC Shares which represents 0.0007% of the Company's issued share capital as at 22 August 2007.

* 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

| Name of Director | Date granted | No. of options granted | Period during which rights exercisable (day/month/year) | Options outstanding as at 1 January 2007 | Options vested during the year | Options lapsed during the year | Options exercised during the year | Exercise price per share of options *(HK$)* | Options outstanding as at 22 August 2007 | Weighted average closing price of shares immediately before the date(s) on which options were exercised *(HK$)* |
|---|---|---|---|---|---|---|---|---|---|---|
| William Chan Fu-keung | 20/9/2000 | 1,066,000 | 5/4/2001 - 11/9/2010 | 217,500 | — | — | — | 8.44 | 217,500 | — |
| Thomas Ho Hang-kwong | 20/9/2000 | 1,066,000 | 5/4/2001 - 11/9/2010 | 321,000 | — | — | — | 8.44 | 321,000 | — |

*Notes:*

1. The Pre-Global Offering Share Option Scheme is valid and effective for a period of ten years after 12 September 2000. No option may be offered to be granted under the Pre-Global Offering Share Option Scheme on or after the commencement of dealings in shares of the Company on Stock Exchange on 5 October 2000.

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

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

| Name of Director | Date granted | No. of options granted | Period during which rights exercisable (day/month/year) | Options outstanding as at 1 January 2007 | Options granted during the year | Options vested during the year | Options lapsed during the year | Options exercised during the year | Exercise price per share of options *(HK$)* | Options outstanding as at 22 August 2007 | Weighted average closing price of shares immediately before the date(s) on which options were exercised *(HK$)* |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 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 | 22/3/2007 | 1,066,000 | 19/3/2008 - 19/3/2017 | — | 1,066,000 | — | — | — | 19.404 | 1,066,000 | — |

*Notes:*

1. No option may be exercised later than ten years after its date of offer and no option may be offered to be granted more than five years after the adoption of the New Joiners Share Option Scheme on 16 May 2002.

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

3. The 1,066,000 share options held by Francois Lung Ka-kui under the New Joiners Share Option Scheme lapsed on 17 October 2006. On 22 March 2007, Francois Lung Ka-kui was granted options to acquire 1,066,000 Shares under the New Joiners Share Option Scheme.

Save as disclosed above:

A none of the Directors 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 as at the Latest Practicable Date, no Director 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.

## 6. DETAILS OF COMPANY SECRETARY AND QUALIFIED ACCOUNTANT

***Company Secretary***

The Company Secretary is Mr. Leonard Bryan Turk. Biographical details are set out in section 4 of this Appendix under the heading "Members of the Executive Directorate".

***Qualified Accountant***

The Company's Qualified Accountant is Mr. Lincoln Leong Kwok-kuen. Biographical details are set out in section 4 of this Appendix under the heading "Members of the Executive Directorate".

## 7. EXPERT'S QUALIFICATIONS AND INTERESTS

The following are the qualifications of the professional advisers who have given an opinion or advice, which is contained in this Circular:

| **Name** | **Qualification** |
|---|---|
| Merrill Lynch | A corporation licensed under the SFO to engage in types 1, 4, 6 and 7 of the regulated activities (as defined in the SFO) |
| KPMG | Certified Public Accountants |
| Jones Lang LaSalle | Qualified Professional Valuers |
| Messrs. King & Wood ("**King & Wood**") | PRC Legal Adviser |
| Messrs. Baker & McKenzie ("**Baker & McKenzie**") | Legal Adviser |

As at the Latest Practicable Date, (other than as disclosed in this Circular) none of Merrill Lynch, KPMG, Jones Lang LaSalle, King & Wood and Baker & McKenzie had any shareholding, directly or indirectly, in any member of the Group or any right (whether legally enforceable or not) to subscribe for or to nominate persons to subscribe for securities in any member of the Group.

As at the Latest Practicable Date, none of Merrill Lynch, KPMG, Jones Lang LaSalle, King & Wood and Baker & McKenzie had withdrawn its written consent to the issue of this Circular, with the inclusion of its reports and/or letters and/or valuation certificates and/or the references to its name and/or its opinion in the form and context in which they are included.

As at the Latest Practicable Date, none of Merrill Lynch, KPMG, Jones Lang LaSalle, King & Wood and Baker & McKenzie had any direct or indirect interest in any asset which had been acquired, or disposed of by, or leased to any member of the Group, or was proposed to be acquired, or disposed of by, or leased to any member of the Group since 31 December 2006, the date to which the latest published audited financial statements of the Group were made up.

## 8. MATERIAL ADVERSE CHANGE

As at the Latest Practicable Date, the Directors were not aware of any material adverse change in the financial or trading position of the Group since 31 December 2006, being the date to which the latest published audited financial statements of the Group were made up.

## 9. MATERIAL CONTRACTS

The following contracts or documents (not being contracts entered into in the ordinary course of business) have been entered into by the Group (or, in the case of the Liaison Committee Letter and Land Comfort Letter, have been received by the Company) within the two years immediately preceding the Latest Practicable Date and are, or may be, material:

(i) Memorandum of Understanding;

(ii) Merger Framework Agreement;

(iii) Service Concession Agreement;

(iv) Sale and Purchase Agreement;

(v) Operating Agreement;

(vi) Memorandum on Performance Requirements;

(vii) KSL Project Management Agreement;

(viii) West Rail Agency Agreement;

(ix) Outsourcing Agreement;

(x) Property Package Agreements; and

(xi) Liaison Committee Letter.

## 10. PARTICULARS OF ANY LITIGATION OR CLAIMS

At the Latest Practicable Date, neither the Company nor any other member of the Group was engaged in any litigation or arbitration of material importance and no litigation or claim of material importance is known to the Directors to be pending or threatened by or against the Company or any other members of the Group.

## 11. DOCUMENTS AVAILABLE FOR INSPECTION

Copies of the following documents are available for inspection during normal business hours at the Company's offices at MTR Tower, Telford Plaza, Kowloon Bay, Hong Kong up to and including the date of the Merger EGM:

(i) the Memorandum and Articles of Association of the Company;

(ii) the annual report including the audited consolidated financial statements of the Company for each of the years ended 31 December 2005 and 2006;

(iii) the interim report for the Company for the six months ended 30 June 2007;

(iv) the annual report including the audited consolidated financial statements of KCRC for each of the years ended 31 December 2005 and 2006;

(v) the Rail Merger Ordinance;

(vi) the MTR Ordinance and subsidiary legislation;

(vii) the KCRC Ordinance and subsidiary legislation;

(viii) the Transaction Agreements;

(ix) the Accountants' Report on KCRC contained in the Appendix to this Circular headed "Accountants' Report on KCRC";

(x) the Report on the unaudited pro forma financial information on the Enlarged Group from KPMG contained in the Appendix to this Circular headed "Financial Information of the Enlarged Group";

(xi) the Property Valuation Report prepared by Jones Lang LaSalle relating to the property interests of the Enlarged Group contained in the Appendix to this Circular headed "Property Valuation Report on the Enlarged Group";

(xii) the material contracts of the Company referred to in the paragraph headed "Material Contracts" in this Appendix to this Circular;

(xiii) the letters of consent from Merrill Lynch, KPMG, Jones Lang LaSalle, King & Wood and Baker & McKenzie; and

(xiv) the Interim Property Valuation Report for 2007 (as referred to in the paragraph headed "Implications under the Listing Rules" in the section of this Circular headed "Letter from the Board").

## 12. LANGUAGE

This Circular has been printed in English and Chinese. In the event of any inconsistency, the English language text of this Circular shall prevail over the Chinese language text.

# MTR CORPORATION LIMITED

## （ 地 鐵 有 限 公 司 ）

(Incorporated in Hong Kong with limited liability)

**(Stock Code: 66)**

**NOTICE OF EXTRAORDINARY GENERAL MEETING**

**NOTICE IS HEREBY GIVEN** that an Extraordinary General Meeting (the "**Merger EGM**") of the shareholders of MTR Corporation Limited (the "**Company**") will be held at Rotunda 3 (6/F) Hongkong International Trade & Exhibition Centre, 1 Trademart Drive, Kowloon Bay, Hong Kong on Tuesday, 9 October 2007 at 11:00 a.m. for the purpose of considering and, if thought fit, passing, the following resolution as an ordinary resolution. Unless otherwise indicated, capitalised terms used herein shall have the same meaning as those defined in the Circular of the Company dated 3 September 2007:

**ORDINARY RESOLUTION**

"**That** for the purposes of implementing the Rail Merger, the Transaction Agreements be hereby approved, confirmed and (in respect of Transaction Agreements previously entered into by the Company) ratified; and that the Chief Executive Officer of the Company or any two members of the Board or two members of the Executive Directorate of the Company be and are hereby authorised to do all such further acts and things and execute such further documents and deeds (and if necessary apply the common seal of the Company thereto) and take all steps which in his/her opinion may be necessary, desirable and expedient to implement and/or give effect to the terms of the Transaction Agreements and the Rail Merger Ordinance and the transactions contemplated thereunder."

By order of the Board
**Leonard Bryan Turk**
*Company Secretary*

Hong Kong, 3 September 2007

As at the date of this notice:

The **Members of the Board** are: Dr. Raymond Ch'ien Kuo-fung (*Chairman*)**, Chow Chung-kong (*Chief Executive Officer*), Professor Cheung Yau-kai*, David Gordon Eldon*, Christine Fang Meng-sang*, Edward Ho Sing-tin*, Lo Chung-hing*, T. Brian Stevenson*, Professor Chan Ka-keung, Ceajer (Secretary for Financial Services and the Treasury)**, Secretary for Transport and Housing (Eva Cheng)** and Commissioner for Transport (Alan Wong Chi-kong)**

The **Members of the Executive Directorate** are: Chow Chung-kong, Russell John Black, William Chan Fu-keung, Thomas Ho Hang-kwong, Lincoln Leong Kwok-kuen, Francois Lung Ka-kui, Andrew McCusker and Leonard Bryan Turk

** independent non-executive Directors*
*** non-executive Directors*

**Registered Office**: MTR Tower, Telford Plaza, Kowloon Bay, Hong Kong

*Notes:*

1. Any member entitled to attend and vote at the meeting convened by the above notice is entitled to appoint one or more proxies to attend and, on a poll, vote instead of him. A proxy need not be a member of the Company.

2. To be valid, a Proxy Form must be completed and delivered to the Company's Registrar, Computershare Hong Kong Investor Services Limited, Rooms 1806-1807, 18th Floor, Hopewell Centre, 183 Queen's Road East, Hong Kong, at least 48 hours before the Merger EGM or adjourned meeting thereof (or 24 hours before a poll is taken, if the poll is not taken on the same day as the Merger EGM or adjourned meeting). **Please return one Proxy Form only. If you deliver more than one Proxy Form your vote may not be counted.**

3. If a Proxy Form is signed under a power of attorney, the power of attorney or other authority relied on to sign it (or a copy which has been certified by a notary or an office copy) must be delivered to the Company's Registrar with the Proxy Form, except that a power of attorney which has already been registered with the Company need not be so delivered. Proxy Forms sent electronically or by any other data transmission process will not be accepted. **Completion and return of a Proxy Form will not preclude a member from attending in person and voting at the meeting or any adjournment thereof should he so wish.**

4. The vote at the Merger EGM will be taken on a poll.

5. The register of members will be closed from 9:00 a.m. on Monday, 8 October 2007 until 4:30 p.m. on Tuesday, 9 October 2007.

6. The translation into the Chinese language of the above notice is for information only.