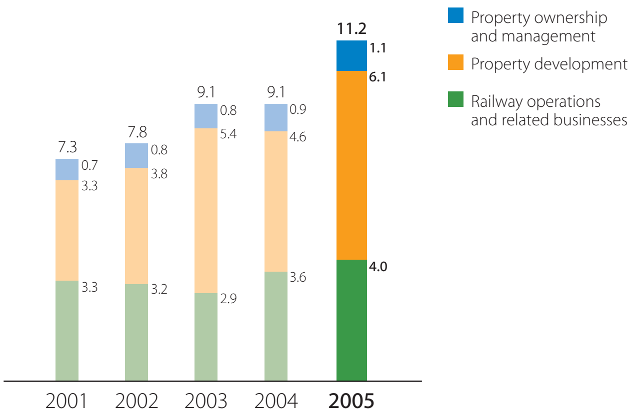
Financial review

Operating profit contributions

Despite higher growth related expenditure, a focus on cost containment helped boost operating profits in all our businesses.

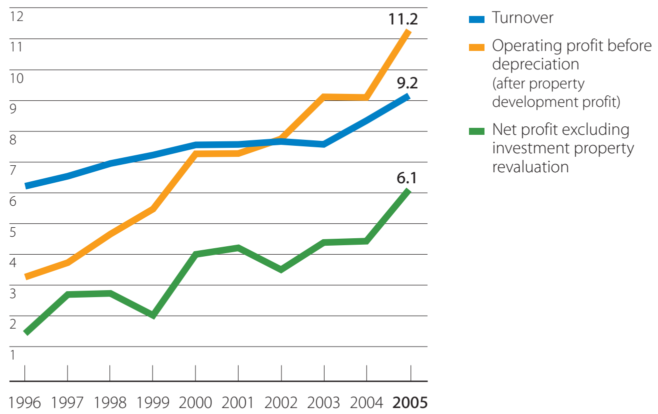
In HK$ billion



Net results from underlying businesses

Strong performances from non-fare businesses and property development activities raised underlying net profit to over HK$6 billion.

In HK$ billion



Review of 2005 financial results

Following the convergence of the financial reporting standards in Hong Kong with the international standards with effect from 1 January 2005, the Company has adopted relevant changes in accounting policies and financial statement presentation to comply with the revised Hong Kong Financial Reporting Standards (HKFRS) which include Hong Kong Accounting Standards (HKAS) and Interpretations (HK-Ints) issued by the Hong Kong Institute of Certified Public Accountants. The implications resulting from adoption of the new standards have been provided in the Notes to the Accounts and comparative figures for 2004 shown in this Report have been restated.

Among the revised or new standards adopted, a few have material impact on the Company's 2005 financial statements. HKAS 40 on investment properties requires the recognition of the change in market value of investment properties in the profit and loss account. Previously the change in market value in investment properties was taken directly to reserve. HKAS 17 on lease requires the land element in leasehold land and building to be accounted for as operating lease, thus resulting in a re-classification of the previous depreciation charge for the land element to operating expense. Both HKAS 40 and HKAS 17 were adopted retrospectively with 2004 comparative figures restated. HKASs 32 and 39 on financial instruments require the marking of derivative instruments to market value. Subject to meeting the requirements to qualify for hedge accounting, those underlying financial liabilities are revalued at their fair values with corresponding adjustments made to their carrying amounts on the balance sheet. The change in value from the previous reporting date is recognised in the profit and loss account or directly taken to hedging reserve in the balance sheet depending on the type of hedging relationship. These standards were adopted prospectively from 1 January 2005. Following HK-Int 2, accounting policy on rails was changed in that certain repair and replacement costs on rails, which were previously charged to the profit and loss account, are now capitalised as fixed assets and subject to annual depreciation charge with effect from 1 January 2005.

It should be emphasised that all of these changes neither affect the Company's cashflow position nor change the Company's underlying business performance.

Profit and loss

Patronage on the MTR Lines increased by 2.9% to a record 858 million in 2005. Average fare on the MTR Lines also increased by 2.6% to HK$6.67 as a result of changes in promotion programmes, including "Ride 10 Get 1 Free" and the opening of DRL. Fare revenues from the MTR Lines therefore increased by 5.6% to HK$5,721 million.

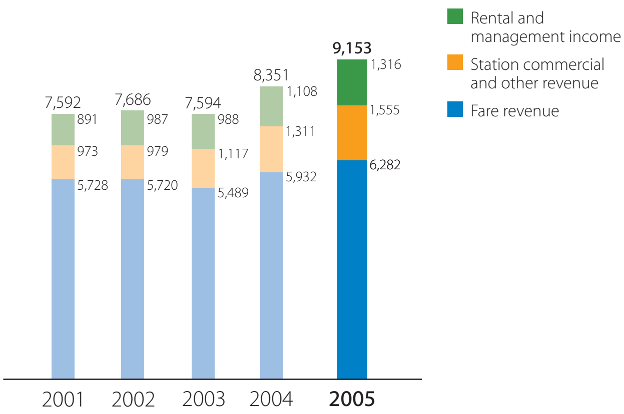
Fare revenue on AEL increased to HK$561 million, 8.9% higher than the HK$515 million recorded in 2004, due to increased patronage and higher average fare, the latter mainly attributable to the change in passenger mix with more passengers taking longer distance journeys.

Non-fare revenue continued to demonstrate strong growth in 2005 of 18.7% to HK$2,871 million, comprising HK$1,555 million from station commercial and other businesses and HK$1,316 million from property ownership and management income. Included in the total non-fare revenue figure was a one-off income received from a mobile phone operator for the early termination of a mobile phone system contract. Excluding this one-off income, total non-fare revenue would have increased by 15%.

Turnover

Strong growth was seen in station commercial, property rental and other businesses as Hong Kong's economy continued to expand.

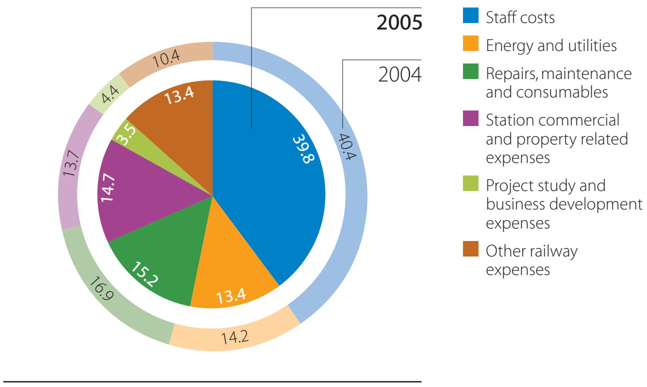
In HK$ million



Operating expenses

Total operating expenses increased from HK$3.8 billion in 2004 to HK$4.1 billion in 2005 to cover additional work requirements for new line and station operations.

Percentage



Advertising income rose by 9.2% owing to the strong economy and new advertising formats. Income from station commercial facilities increased by 15.4% as a result of increased patronage, strong consumer spending and higher rental income achieved after station renovation. Income from consulting business increased by 15.9% as new consulting contracts were secured whilst income from other miscellaneous activities rose by 23.8% due to connection fees received from new station entrances and increased income from publications.

With the opening of a new shopping centre and full-year effect of office and car park rental at Two IFC, together with rental increases after tenancy renewal, income from property ownership and management rose by 18.8% from 2004. All these favourable factors compensated for the relatively stagnant growth in telecommunication income.

Despite the increased scope of business from the opening of new line and stations, the new shopping centre and increased business development activities, operating costs were contained at HK$4,052 million or 6.0% higher than last year, but still below the revenue growth rate of 9.6%. Two items need to be highlighted relating to costs, which are the accounting treatment of rails and one-off property revaluation write-back in the 2004 financial year.

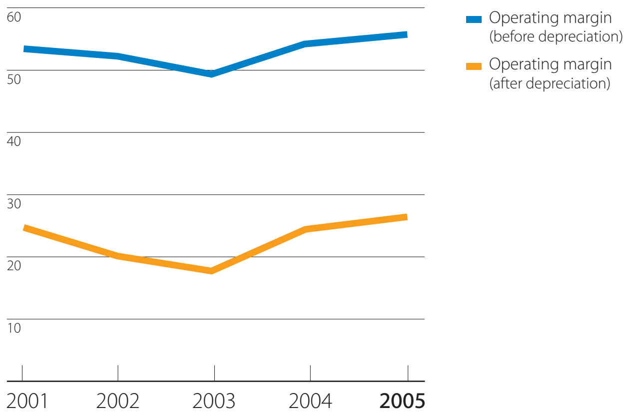
With effect from 1 January 2005, rails repair and replacement costs are capitalised as fixed assets on the balance sheet, thereby increasing depreciation charges. Previously, these costs were included as operating costs in the profit and loss account and the change had led to a reduction in operating cost in 2005 of HK$45 million, with a corresponding increase in depreciation of HK$75 million. The second item is the write-back in 2004 of HK$69 million of revaluation deficit incurred in 2003 in respect of the self-occupied headquarter building, which reduced operating costs in 2004. Excluding these two items, operating costs increased by HK$206 million or 5.4% compared to 2004.

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

Operating profit from railway and related operations before depreciation amounted to HK$5,101 million, an increase of 12.6% from HK$4,529 million in 2004. Operating margin improved from 54.2% in 2004 to 55.7% in 2005, the highest for the last 10 years.

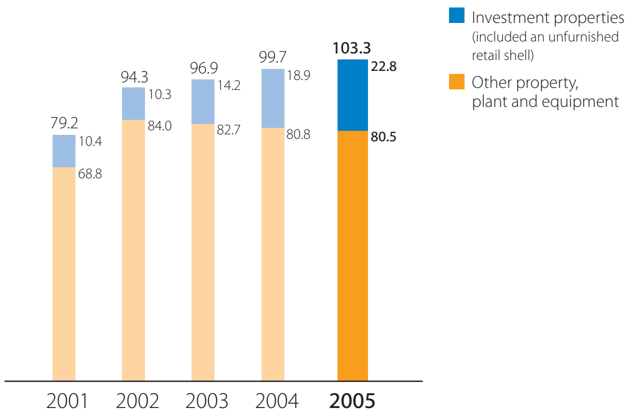
Operating margin

Operating margin before depreciation improved from 54.2% to 55.7%, the highest in the past 10 years of operations.



Fixed assets growth

Property revaluation, receipt of The Lane and capitalisation of Disneyland Resort Line and AsiaWorld-Expo Station were factors in the growth of fixed assets.



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

Operating profit before depreciation was HK$11,246 million, an increase of 23.6% from HK$9,097 million in 2004. Depreciation charge in 2005 amounted to HK$2,682 million, which was 7.3% above 2004 mainly due to the change in rail capitalisation policy as mentioned above, fully depreciating certain telecommunication equipment upon the early termination of a mobile phone system contract, and the completion of DRL, the platform screen door project and station renovations in the second half of 2005.

Despite higher interest rates since the second half of the year and interest expense no longer being capitalised to DRL following its commencement of operations, net interest expense of the Company in 2005 dropped by 6.1% to HK$1,361 million mainly due to reduced borrowing. With higher interest rates, our average interest cost increased from 4.7% in 2004 to 5.1% in 2005, while interest cover improved from 6.1 times in 2004 to 7.6 times in 2005. In compliance with HKAS 40, the revised accounting standard on investment properties, the increase in market value of the Company's investment properties, amounting to HK$2,800 million pre-tax (HK$2,310 million post tax), was recognised in the profit and loss account.

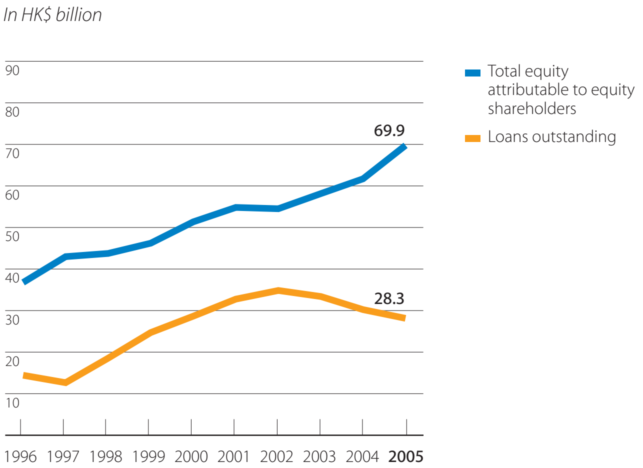
The Company's share of net profit of OHL amounted to HK$40 million, which was a 2.6% increase from 2004. During the year, the Company also engaged in the bidding of operating franchises in Europe via jointly controlled entities established with joint venture partners. The share of net loss of these entities in 2005 amounted to HK$31 million. Tax expense, including current tax expense in China and overseas business activities and deferred tax provision, increased by 37.1% to HK$1,549 million. The resulting net profit of the Group in 2005 amounted to HK$8,463 million, a 29.3% increase from 2004, with HK$8,450 million attributable to equity shareholders, an increase of 29.1% from 2004. Earnings per share therefore increased from HK$1.23 in 2004 to HK$1.55 in 2005.

Excluding investment property revaluation and the related deferred tax, underlying profit for MTR Corporation was HK$6,140 million or HK$1.13 per share, increase of 36.7% and 34.5% respectively from 2004.

The Board has recommended a final dividend of HK$0.28 per share, amounting in total to HK$1,535 million, with a scrip dividend option offered to all shareholders except shareholders with registered addresses in the United States of America or any of its territories or possessions. As in previous years, the Government 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.

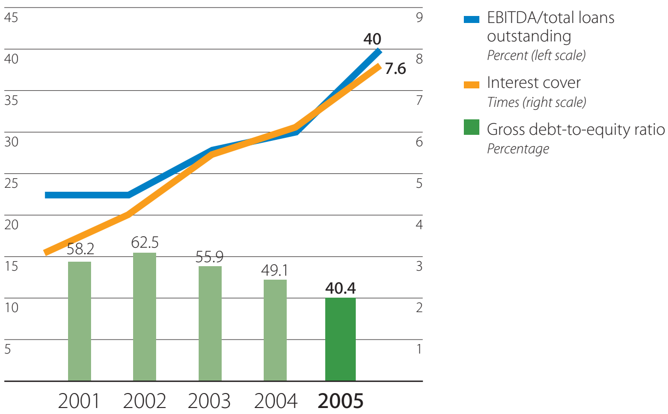
Debt/equity profile

Increased profitability and reduced borrowings due to stronger cash flow further improved our debt/equity profile.



Debt servicing capability

Higher operating profit coupled with reduced borrowings led to strong improvement in both the EBITDA / total outstanding loans ratio and interest cover.



Balance sheet

The Group continues to be well capitalised, with the bulk of our assets invested in the railway system. Total fixed assets increased from HK$99,692 million in 2004 to HK$103,275 million as at 31 December 2005, mainly attributable to surpluses in investment property revaluation, the receipt of The Lane and the capitalisation of DRL and AsiaWorld-Expo Station upon commissioning in August and December 2005 respectively.

Railway construction in progress increased slightly from HK$962 million in 2004 to HK$1,006 million as at 31 December 2005, comprising mainly additional capital expenditures on the Tung Chung Cable Car and SkyPlaza Platform projects, which were partly reduced by the transfer out of DRL and AsiaWorld-Expo Station costs to fixed assets upon completion.

Property development in progress represents the costs incurred in the sites for property development less reimbursement already received from developers. Property development in progress as at 31 December 2005 increased to HK$2,756 million from HK$2,088 million in 2004, mainly due to the payment of half of the land premium of HK$1,160 million for the Package One development of Tseung Kwan O Area 86, partially reduced by further cost reimbursement received from developers relating to Olympic Station Package Three, Tiu Keng Leng and Tseung Kwan O Area 86 developments.

Properties held for sale increased to HK$1,311 million from HK$815 million in 2004, comprising mainly residential units at The Arch in Kowloon Station.

In line with the requirement of HKAS 39, the new accounting standard on financial instruments, the Company recognised the fair value of derivative instruments in our balance sheet prospectively from 2005 onward, and accordingly recorded derivative financial assets and liabilities of HK$234 million and HK$307 million respectively as at 31 December 2005.

Debtors, deposits and payments in advance increased significantly to HK$3,095 million from HK$1,276 million in 2004 primarily due to an increase in amounts receivable relating to the pre-sale of properties from The Arch.

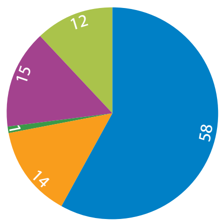
Total loans outstanding at year-end were HK$28,264 million, a decrease of HK$2,114 million compared with 2004, due to loan repayments. Loans drawn down during the year amounted to HK$5,291 million which were primarily for refinancing purposes.

Deferred income decreased from HK$4,638 million in 2004 to HK$3,584 million following profit recognition at Tung Chung, Kowloon and Olympic station development packages, in accordance with the progress of property construction and pre-sales activities, offset by an additional payment of HK$936 million received in respect of Olympic Package Three development in January.

Sources of borrowing

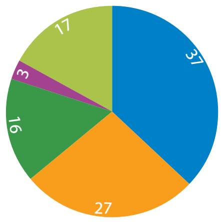
Whilst Hong Kong remains its main market, the Company continued its strategy of diversifying its funding sources.

Percentage (As at 31 December 2005)



By market

- Hong Kong
- US
- Japan
- Europe
- Asia (excluding Japan)



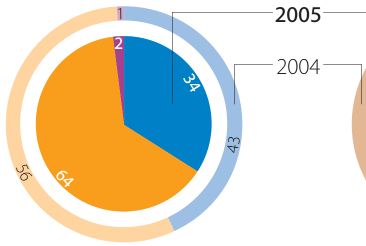
By instrument

- US$ Global bonds
- Medium term notes
- US$ Eurobonds
- HK$ bonds
- Bank loans & export credits

Use of interest rate and currency risk hedging products

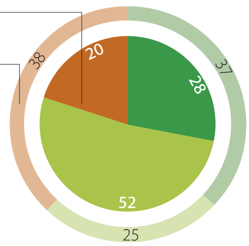
MTR Corporation is an active user of derivatives, but solely for hedging borrowing related interest rate and currency risks and not speculation.

Percentage (As at 31 December 2005)*



By instrument

- Interest rate swaps and options
- Cross currency & interest rate swaps
- Foreign exchange forwards



By maturity

- Beyond 5 years
- 2 to 5 years
- Within 2 years

** Calculated based on nominal value*

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

Share capital, share premium and capital reserve increased by HK$1,181 million to HK$37,450 million at year-end, as a result of shares issued for scrip dividend and share options exercised. Together with increases in fixed asset revaluation and other reserves of HK$501 million, opening adjustments on adoption of HKASs 32 and 39 of HK$124 million and retained earnings net of dividends of HK$6,177 million, total equity attributable to equity shareholders increased to HK$69,875 million from HK$61,892 million as at 31 December 2004. As a result, the Group's gross debt-to-equity ratio improved from 49.1% to 40.4% at 2005 year-end and net debt-to-equity ratio from 48.6% to 39.9%.

Cash flow

Net cash inflow generated from railway and related activities increased from HK$4,486 million in 2004 to HK$5,189 million for the year, while cash receipts from developers and purchasers in respect of property development projects also increased from HK$2,576 million for the previous year to HK$2,610 million. Outflows for capital project payments, including half of the land premium for Tseung Kwan O Area 86 Package One development and interest expenses amounted to HK$3,454 million and HK$1,416 million respectively, as compared to HK$2,889 million and HK$1,301 million for the previous year. Together with other minor movements, net cash flow before dividends and loan repayments was HK$2,823 million, being HK$257 million higher than last year. After dividend payments of HK$1,138 million and net loan repayment of HK$1,598 million, there were net cash inflows of HK$87 million compared to net outflows of HK$106 million in 2004.

Financing activities

New financings

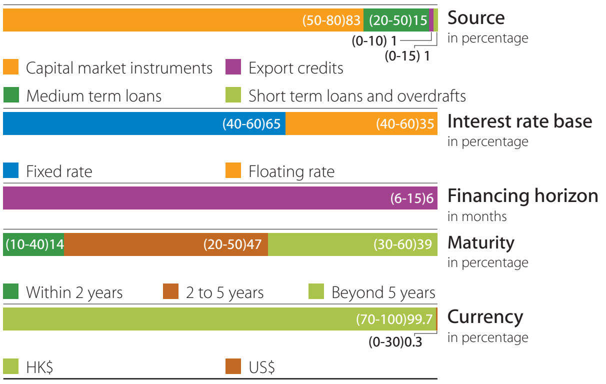
2005 began with Hong Kong interest rates remaining below US rates as a result of excess liquidity and strong capital inflows. Following the introduction by the Hong Kong Monetary Authority of the "Two-Way Convertibility Undertaking" in May, short-term Hong Kong interest rates rose quickly to levels similar to but still below US rates, and have since tracked closely and risen in tandem with US rates as the US Federal Reserve continued to tighten. By the end of 2005, the 3-month Hibor rate had increased substantially from the pre-Undertaking levels.

Long-term rates have also trended up since introduction of the "Two-Way Convertibility Undertaking" in line with US rates after reaching a trough in June, albeit less significantly than short-term rates. The Group took advantage of the historical low fixed rate levels, and in April and June launched a total of HK$1.5 billion in fixed rate medium term notes (MTN) via private placements. These comprised a HK$500 million 10-year note and two HK$500 million 15-year notes with coupon rates of 4.5%, 4.28% and 4.75% respectively.

Preferred financing model and debt profile

MTR Corporation's disciplined approach to debt management ensures a well balanced and diversified debt portfolio.

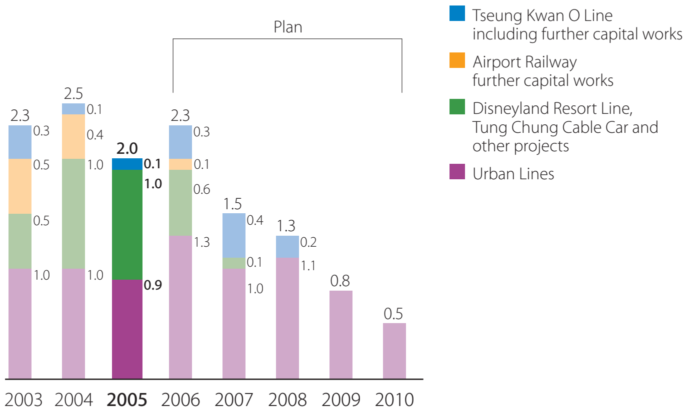
(Preferred Financing Model) vs. **Actual debt profile** *As at 31 December 2005*



Investment in new railway lines and existing network in Hong Kong

Total projected capital expenditures between 2006-2008 of HK$5.1 billion are based on the existing network and committed projects.

In HK$ billion



The banking market in Hong Kong remained highly liquid throughout the year and credit spreads were tight. These favourable conditions enabled the Group to enter into a number of 7-year and 10-year bilateral facilities with some of our key relationship banks at very attractive terms. These comprised HK$2.2 billion in 7 years and HK$1.0 billion in 10 years, which together with the HK$1.5 billion in MTN helped raise a total of HK$4.7 billion of new financings for the Group.

As at the end of 2005, the Group had total undrawn committed facilities of HK$5.3 billion. These facilities together with new MTN issued and new bank loan commitments obtained in early 2006 are expected to be sufficient to cover all our anticipated funding needs in 2006.

Our subsidiary and associate successfully arranged three bank loans, one for Shenzhen Metro Line 4 and two for Beijing Metro Line 4. All these loans are non-recourse to MTR Corporation. Based on a detailed term sheet initialled with China Development Bank, the project loan for Shenzhen Metro Line 4 comprises a 25-year RMB3.6 billion non-recourse bank loan and will be used to fund 60% of the Group's investment in the RMB6.0 billion project. Partners of the PPP associated company for Beijing Metro Line 4 have also initialled two separate loan agreements with Industrial and Commercial Bank of China and China Development Bank, which provide for two non-recourse 25-year project loans, each of RMB1.6 billion, for Beijing Metro Line 4. In addition to the long maturity and RMB denomination, which serve to reduce respectively refinancing and exchange rate risks, the loans also provide fixed rate funding of between 5 and 15 years, which will help mitigate interest rate risk and control interest costs of the projects.

Cost of borrowing

With the Group's conservative mix of fixed and floating rate debt and ability to secure attractive fixed rate long-term financings, exposure to interest rate risk was well contained. As a result, despite significantly higher short-term interest rates since the beginning of the second half, average borrowing cost for the year increased only marginally to 5.1% from 4.7% in 2004, and gross interest expense increased by HK$4 million as compared with 2004.

Risk management

We continued to manage our financing activities and debt portfolio in accordance with our 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. As a result, the Company was able to maintain a well diversified debt portfolio with adequate coverage for anticipated future funding needs.

The Company is one of the most active corporate users of derivative financial instruments and in accordance with Company policy uses these instruments solely for hedging borrowing related interest rate and currency risks and not for speculation or trading purposes. To monitor and control counterparty risk exposure, we deal only with counterparties with credit ratings of A-/A3 or better, and assign to these counterparties limits based on their credit ratings. In addition, we have adopted a risk monitoring framework based on the widely accepted "value-at-risk" methodology and "expected loss" concept to quantify and monitor these exposures.

Credit ratings

The Company was the first Hong Kong corporate entity to have obtained internationally recognised credit ratings and has since maintained strong ratings on par with the Hong Kong SAR Government based on our strong credit fundamentals, prudent financial management and continuous Government support.

In July, Moody's re-affirmed the Company's short-term foreign currency and long-term domestic currency ratings at respectively P-1 and Aa3 with a stable outlook, and based on a new rating methodology upgraded the long-term foreign currency debt rating if such debt is issued under foreign laws to Aa3, higher than Hong Kong sovereign's A1 rating.

In the same month, S&P's affirmed our ratings at A-1+ and AA- for short/long-term local currency ratings and concurrently upgraded our short/long-term foreign currency ratings to respectively A-1+ and AA- with a stable outlook in line with the corresponding upgrade of Hong Kong's sovereign ratings.

Credit ratings

	Short-term ratings*	Long-term ratings*
Standard & Poor's	A-1+/A-1+	AA-/AA-
Moody's	–/P-1	Aa3/Aa3
Rating and investment Information Inc. (R&I)	a•1+/–	AA/AA-

* Ratings for Hong Kong dollar/foreign currency denominated debts respectively.

In December 2005, R&I also re-affirmed the Company's short-term local currency and long-term domestic/foreign currency ratings at respectively a•1+ and AA/AA-.

Financial planning

We continued to use our comprehensive long-term financial planning model based on well-established methodologies to plan our railway operations and to evaluate new projects and investments. The model subjects all investment proposals to rigorous evaluations that take into account our weighted average cost of capital and required rate of return. To ensure our assumptions are realistic and robust, we also carefully review all key assumptions used in the model on a frequent basis, and conduct necessary sensitivity analyses on key variables, taking into account present business and economic conditions, and future likely changes. To manage our cost of capital effectively, detailed assessment of our funding requirement and capital structure is conducted on a regular basis.

Financing capacity

The Company's current projected capital expenditure programme comprises three parts – railway and property projects in Hong Kong, and overseas investment. For railway projects in Hong Kong, it consists mainly of capital costs for sustaining and upgrading existing lines as well as investment in new railway projects. For property development, the main components are fit-out work for Elements and refurbishment of Telford Plaza. For overseas investments, it consists mainly of the construction cost for Shenzhen Metro Line 4, equity investment for Beijing Metro Line 4 and refurbishment cost for Beijing Oriental Kenzo. Based on this programme, total capital expenditures for the next three years between 2006 and 2008 are projected to be approximately HK$5.1 billion for railway projects and HK$2.1 billion for property investment in Hong Kong, and HK$5.4 billion for overseas projects. In addition, the Company will provide a HK$4.0 billion interest free loan to the developer of Tseung Kwan O Area 86 Package Two. Amongst these projections, the funding requirement for the HK$4.0 billion interest free loan and the Shenzhen Metro Line 4 project has already been secured, and as such the Group has sufficient financing capacity to capture other investment opportunities, such as WIL and the South Island Line (East) and (West) in Hong Kong, as well as new projects in Shenzhen, Beijing and Wuhan in Mainland China.