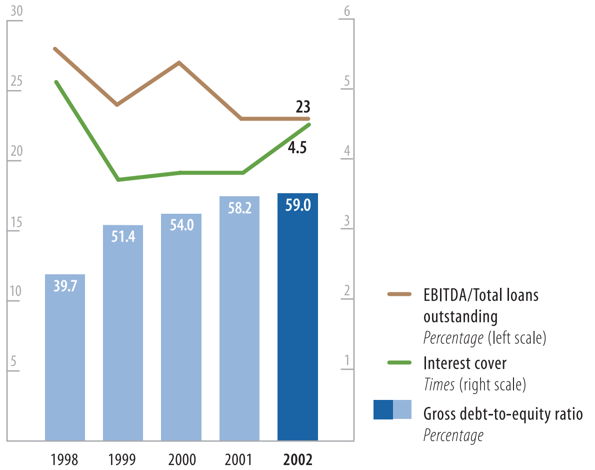
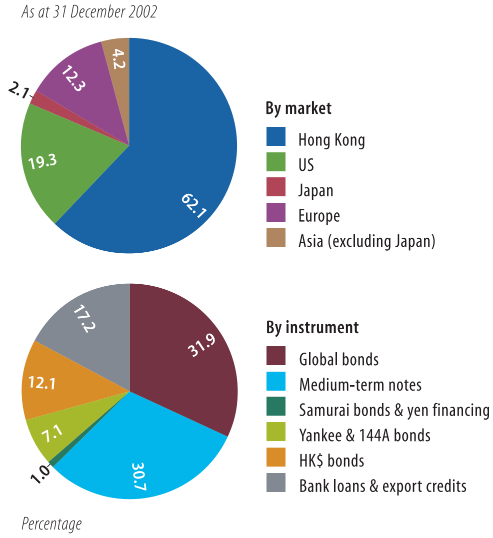
Financial review



Debt servicing capability

MTR's debt service ability improved further in 2002 with interest cover increasing from 3.8 times in 2001 to 4.5 times.



Sources of borrowing

The Hong Kong dollar debt market offered attractive funding opportunities in 2002, and a HK$3.5 billion retail bond issue raised the Hong Kong dollar portion of debt outstanding.

Financing achievements

During 2002, the Hong Kong dollar debt market remained highly liquid due to continued lack of investment demand and loan growth, resulting in attractive pricing relative to other markets. MTR therefore continued to focus on the Hong Kong dollar debt market in executing and completing its financing programme for the year, which by comparison with the previous year was modest.

Groundbreaking retail bond issue

With bank deposit rates staying at historical low levels, the year also witnessed a rapid development in the Hong Kong retail bond market as individual investors increasingly turned to retail bonds for more stable and higher returns.

The Group took advantage of this important development and successfully launched a retail bond in May, becoming the first publicly listed company in Hong Kong to do so. The issue, comprising a 2-, 3- and 4-year tranche, was offered to the public through nine placing banks. The issue attracted total subscriptions of more than HK$5.6 billion from over 18,000 applicants, setting a new record for both size and number of investors for a Hong Kong bond issue. Based on this overwhelming response, balanced against the Group's funding requirement, the issue size was increased from the original underwritten amount of HK$1 billion to HK$3.5 billion.

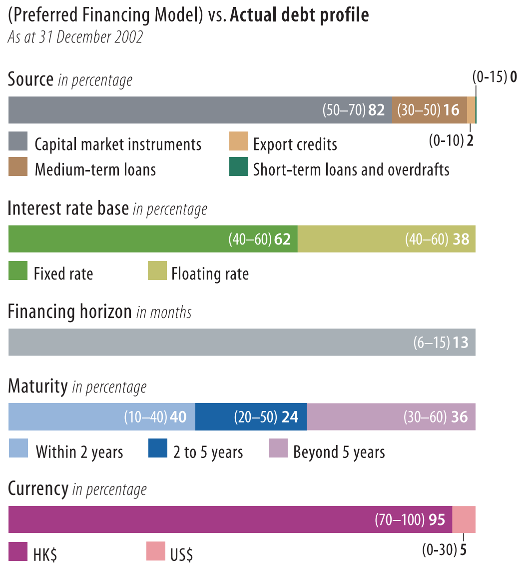
The Group was very pleased with the success of the transaction. Not only did it help diversify its funding sources and provide very cost effective funding, it also set an important benchmark for the retail bond market in Hong Kong, helping its development.

Modest funding requirements

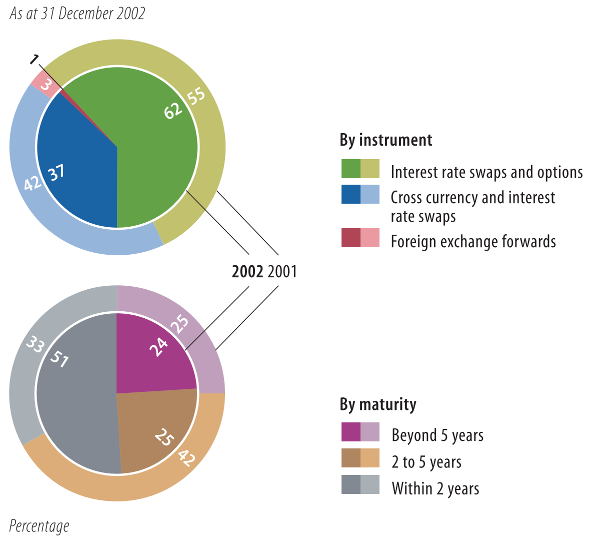
The completion of the Tseung Kwan O Extension project and the Government's waiver of its cash dividend to support the Penny's Bay Rail Link resulted in a modest financing requirement for the year when compared with previous years. The retail bond issue covered all funding needs for the year whilst helping, together with previously arranged but undrawn banking facilities, to preserve a prudent financing horizon. As of the end of 2002, the Company had total undrawn committed facilities of HK$6 billion, sufficient to meet its projected funding needs up to early 2004.

Benchmark bonds perform well

During 2002, the US dollar bond market was characterised by significant volatility and widening credit spreads as a result of economic uncertainties, as well as a growing number of corporate failures and accounting scandals. Despite these difficulties, the Company's Global and Yankee bonds continued to attract a strong following in the international markets, with secondary spreads continuing on a downward trend during much of the year. Secondary spreads of the MTR 2010 Global bond tightened to as low as 65 basis points over the yield of 10-year US treasuries, from 110 basis points at the beginning of the year. This impressive performance against a backdrop of significant market volatility, together with the Company's strong credit ratings at Hong Kong's sovereign level, confirms the benchmark status of the Company's US dollar bonds.



Preferred financing model and debt profile
MTR continued to adhere to the guidelines of its successful Preferred Financing Model, which imposes prudent diversification on its debt portfolio.



Use of interest rate and currency risk hedging products
MTR makes active use of derivatives instruments to hedge interest rate and currency exposures, but not for speculative purposes.

Cost of borrowing declines

Despite a brief upsurge in interest rates early in the year, interest rates on the whole were on a downward trend in 2002 as the world's major economies continued to face insufficient demand and modest growth, forcing their central banks to continue to ease monetary conditions against a background of low inflation.

Lower interest rates and the ability of the Group to secure cost effective funding via the retail bonds and other credit facilities enabled the Group to reduce its interest cost significantly while maintaining a conservative mix of fixed and floating rate debt to control interest rate risk. The average borrowing cost for the year was reduced to 5.4% from 6.6% in 2001, leading to a HK$157 million reduction in gross interest expense. Interest expense charged to the profit and loss account, however, increased from HK$874 million in 2001 to HK$1,125 million in 2002 as, following the opening of the Tseung Kwan O Line, the related borrowing costs were no longer capitalised to this project and instead were expensed.

No new equity financing raised

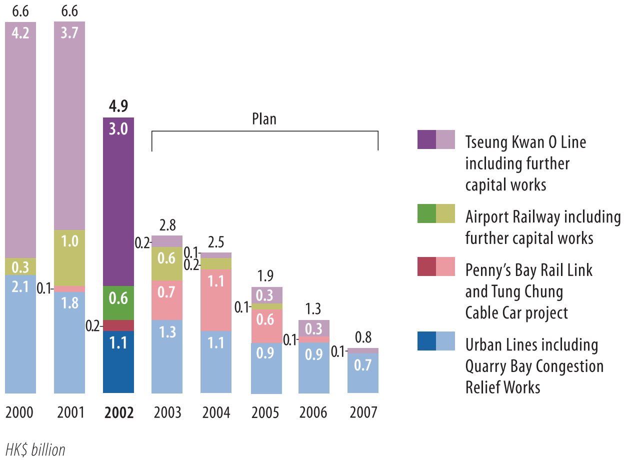
In March 2002, Hong Kong's Financial Secretary in his budget speech indicated that the Government would proceed with the sale of the second tranche of MTR shares in its fiscal year ending March 2003, subject to maintaining a not less than 50% shareholding in the Company for at least 20 years from the date of the initial public offering. Owing to the subsequent announcement by the Government of the feasibility study on the possible merger of MTR and the Kowloon-Canton Railway Corporation, however, a firm timetable for the sale has yet to be established.

During the year, in view of our strong balance sheet, modest financing requirement, the very favourable interest rate environment and the Company's strong debt financing capacity, we did not raise any capital through new equity financing.

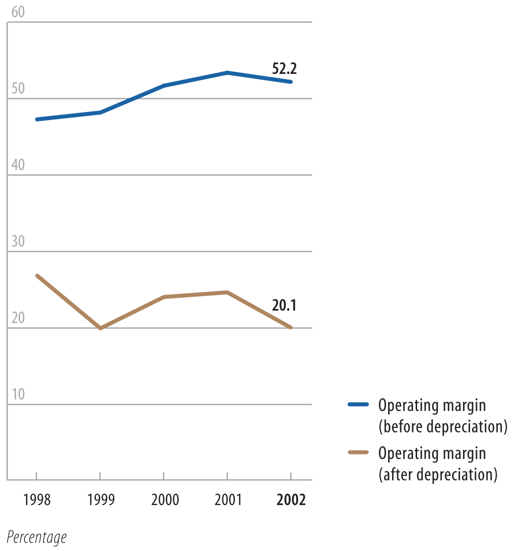
Sound risk management

During the year we continued to manage our financing activities and debt portfolio on a prudent basis in accordance with the Preferred Financing Model. The Preferred Financing Model was established in the 1980's and has since been the cornerstone of the MTR's disciplined approach to fund raising and risk management, helping it to weather significant market volatility over the years. The Model 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. By adhering to the Model, the Company continued to maintain a well-diversified debt profile with adequate forward coverage throughout 2002.

In managing debt related interest rate and currency risks and to achieve a debt profile guided by the Preferred Financing Model, we continue to make active use of off-balance sheet financial derivative instruments such as interest rate and cross currency swaps. By policy, these instruments are used solely for hedging purposes and not for speculation. To monitor and control



Investment in new railway lines and the existing networks
Following the opening of the Tseung Kwan O Line, MTR's capital expenditure in the coming years will be modest, leaving ample financial capacity for new investment opportunities.



Operating margins
Operating margin after depreciation fell due to the increase in depreciation charge after capitalisation of the Tseung Kwan O Extension project costs following its opening.

counterparty risk exposure, we generally deal only with counterparties with credit ratings of single A or better. In addition, we have developed and are using a framework based on the widely accepted "value-at-risk" methodology and "expected loss" concept to further quantify and control counterparty risk.

Credit ratings reaffirmed

Despite the challenging economic environment, which has negatively impacted the credit ratings of issuers with even the highest quality including sovereigns and multinationals, MTR's credit ratings remained strong during the year, staying at par with the sovereign ratings of the Hong Kong SAR Government. We were the first Hong Kong corporate borrower to obtain international credit ratings and have since enjoyed the same ratings as the Hong Kong Government from Moody's, Standard & Poor's and R&I.

In May 2002, Moody's reaffirmed our short-term foreign currency and long-term domestic/foreign currency ratings at respectively P-1 and Aa3/A3. In August 2002, Standard & Poor's also reaffirmed our long-term domestic/foreign currency ratings at AA-/A+, and our short-term domestic/foreign currency ratings at A-1+/A-1. The Company's credit ratings from R&I at AA/AA- for long-term domestic/foreign currency debts and a-1+ for short-term local currency debt were also reaffirmed in the same month. In October 2002, Standard & Poor's revised its outlook on the long-term local currency rating of AA- on the Hong Kong SAR Government to negative from stable. Accordingly, the rating agency also changed its outlook on the Company's long-term local currency rating to negative from stable, but re-affirmed its long-term AA- local and A+ foreign currency ratings and its stable outlook on the foreign currency ratings.

Credit ratings

	Short-term ratings*	Long-term ratings*
Standard & Poor's	A-1+/A-1	AA-/A+
Moody's	–/P-1	Aa3/A3
Rating and Investment Information Inc. (R&I)	a-1+/–	AA/AA-

* Ratings for Hong Kong dollar denominated debt and foreign currency denominated debt respectively.

Rigorous financial planning

Prudent financial planning has always been a hallmark of the Company's financial management and this is particularly important given the current challenging economic and operating environments. We have a well established and sophisticated long-term financial planning model based on a clear methodology for evaluating new projects and investments. Each year, the key assumptions are carefully reviewed as part of our budgeting exercise and sensitivity analyses are conducted on the key variables. All investment proposals are subject to this rigorous evaluation process that takes into account weighted average cost of capital and a required rate of return. To manage our cost of capital effectively, detailed assessments of the funding requirement and capital structure are conducted on a regular basis.

Funding capacity for new projects

In July 2002, we were awarded both the Penny's Bay Rail Link and the Tung Chung Cable Car projects, with estimated project costs of respectively HK$2 billion and HK$750 million. To enable the Company to earn an acceptable rate of return on the Penny's Bay Rail Link project, the Government agreed to waive cash dividends