Express fleet and some of the MTR Lines trains. The transaction generated a substantial net present value financial benefit which will be progressively recognised as income over the relevant lease terms.

Cost of borrowing

Despite signs of faster growth in the United States, the Federal Reserve continued to keep interest rates low throughout the year due to continuing excess capacity in the economy and low inflation. This accommodative monetary policy, together with strong liquidity in the market, helped push both short and long term interest rates in the United States and Hong Kong to historical lows.

As a result of the low interest rates and the attractive terms of the new financings obtained during the year, the Group was able to reduce further its overall borrowing cost to 5.1% from 5.4% in 2002, resulting in reduction of gross interest expense by HK$102 million.

Risk management

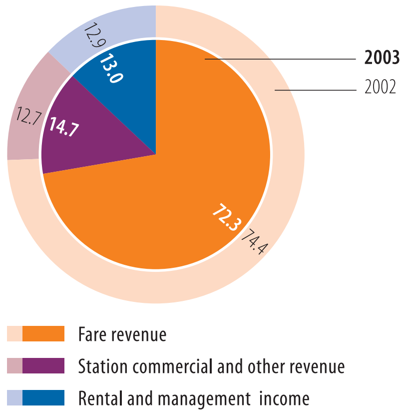
The Company has long adopted a Preferred Financing Model to provide guidance and a disciplined approach to its fund raising activities. Established in the 1980's, the Model aims to achieve risk diversification of our debt portfolio by specifying the preferred mix of fixed and floating rate debts, the 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. During the year, the Company continued to manage its financing activities in accordance with the Model with the result that its debt portfolio remained well balanced with good coverage of anticipated future funding needs.

We also remained one of the most active corporate users of off-balance sheet financial derivative instruments for hedging the borrowing related interest rate and currency risks. Based on Company policies, derivatives are used solely for hedging purposes and not for speculation. To better monitor and control counterparty risk exposure, we have also adopted the policy of dealing only with counterparties with credit rating of A-/A3 or above, and have developed and adopted a risk monitoring framework based on the widely accepted "value-at-risk" methodology and "expected loss" concept.

Turnover

A small decline in fare revenues was offset by overall gains at MTR's other businesses.

Percentage



Credit ratings

The Company was the first Hong Kong corporate borrower to obtain, in 1987, internationally recognised credit ratings and has since maintained ratings on par with the Hong Kong SAR Government based on its strong credit fundamentals, prudent financial management and continued Government support.

During 2003, Moody's affirmed the Company's short-term foreign currency and long-term domestic/foreign currency ratings at respectively P-1 and Aa3/A3 in April, and subsequently in August upgraded the long-term foreign currency rating by two notches to A1 with a stable outlook after a similar change to Hong Kong's sovereign rating.

S&P's also confirmed that our ratings remained unchanged at A-1+/A-1 and AA-/A+ for short-term domestic/foreign currency and long-term domestic/foreign currency borrowings respectively in April with a stable/negative outlook respectively on the foreign and domestic currency rating in line with the Hong Kong SAR Government. R&I re-affirmed our short-term local currency and long-term domestic/foreign currency ratings at respectively a-1+ and AA/AA- in September.

Financial planning

Railways are capital intensive projects with a long return period. Prudent financial planning is therefore critical to the success of a railway company such as MTR, particularly given the current challenging economic and operating environments. Over the years, we have developed and adopted a comprehensive long-term financial planning model using well-established methodologies for evaluating new projects and investments. The model subjects all investment proposals to a rigorous evaluation process that takes into account weighted average cost of capital and a required rate of return. In reviewing overseas investments we seek returns which will compensate the Company for the geographic, project and other risks taken. Each year, we carefully review the key assumptions going into this model as part of our budgeting exercise and conduct the necessary sensitivity analyses on key variables. To manage our cost of capital effectively, we also undertake regular detailed assessment of our funding requirement and capital structure.

Financing capacity

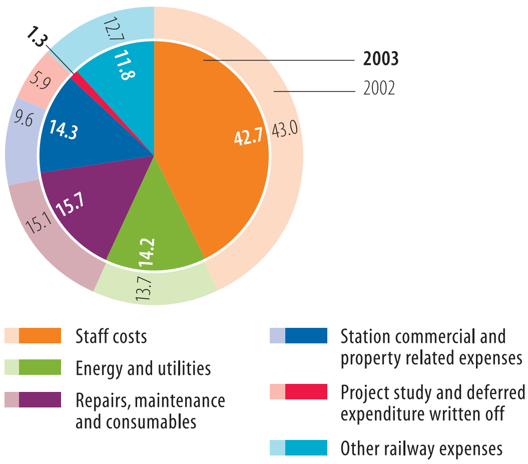
The Company's current committed capital expenditure programme comprises mainly the maintenance and upgrade of the existing lines, and construction of the Penny's Bay Rail Link and the Tung Chung Cable Car, with the latter two projects having an estimated completion cost of respectively HK$2 billion and HK$0.95 billion. Taking into account the relatively small scale of these projects and our ongoing efforts in streamlining capital works, capital expenditures for the next three years between 2004 and 2006 are expected to be modest with an estimated programme of around HK$7.4 billion. In the light of this, MTR will have strong financing capacity to capture and fund new projects and investment opportunities, such as Shenzhen Line 4 and the South Island Line extension in the next few years.

For Shenzhen Line 4, subject to finalisation of the relevant agreements and approvals by the various authorities, the bulk of the expenditure will likely be incurred after 2005. It is planned that the 40% equity investment in this project will be financed by a combination of internally generated funds and external borrowing by the Company whilst the balance of 60% of the project cost will be funded by non-recourse project financing in RMB. As to the South Island Line, we will examine the capital structure and funding alternatives at the appropriate time if and when Government approval is obtained.

Operating expenses

Operating expenses were contained well, rising a modest 4.8% despite the full year operation of the Tseung Kwan O Line.

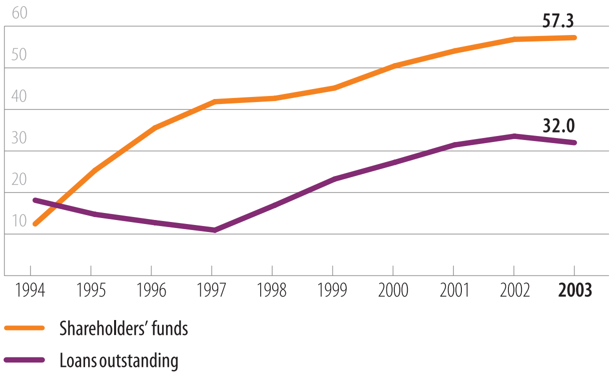
Percentage



Debt/equity profile

Total loans outstanding decreased during 2003, which together with an increase in shareholders' funds helped improve the gross debt/equity ratio to 55.9% at year end.

In HK$ billion



Fixed assets growth

The retained investment space at Two IFC boosted fixed assets.

In HK$ billion