Financing activities

New financings

In June 2004, in an effort to pre-empt inflation, the US Federal Reserve started to remove the extra stimulus in its monetary policy successively raising the Fed Funds target rate from a historical low of 1.0% to 2.25% by the end of the year. Prior to the Federal Reserve's decision, the Group took advantage of the favourable market conditions resulting from strong global liquidity and a benign inflation outlook to successfully launch a US$600 million 10-year fixed rate bond in January. The offering attracted strong interest, with total subscriptions of close to US$1.9 billion from over 130 accounts representing a diverse group of institutional investors including banks, insurance companies, pension funds and money managers across Asia and Europe.

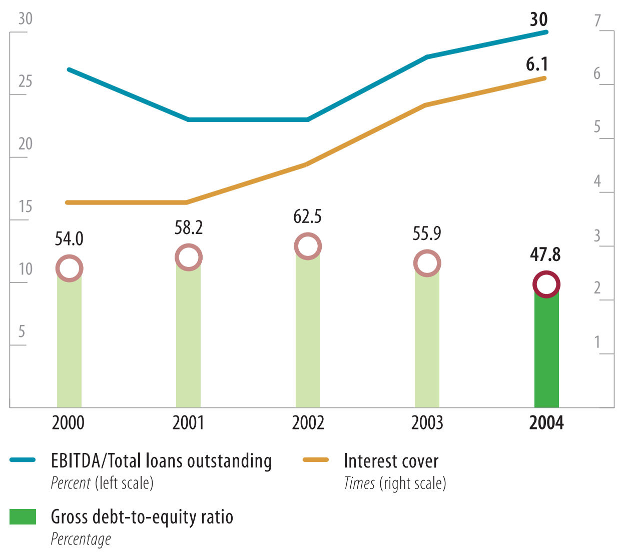
This very strong demand together with the historical low rates enabled the Group to price the bond at an attractive re-offer spread of 83 basis points over the comparable yield of 10-year treasuries with a coupon rate of 4.75%, and to increase the size of the transaction to US$600 million from the originally planned US$500 million. The transaction enabled the Group not only to obtain very cost-effective fixed rate long-term funding and further extend our debt maturity profile, but also to establish a new 10-year US dollar benchmark for Hong Kong's quasi-sovereign credits.

Despite the actions of the Federal Reserve, interest rates in Hong Kong remained low throughout the year as a result of continuing strong capital inflow amid speculation of an imminent revaluation of the Renminbi and strong IPO activities. Later in the year, the Group took advantage of these favourable conditions to tap the Hong Kong dollar fixed rate market and arrange a total of HK$500 million fixed rate bonds, comprising HK$200 million in 12-year and HK$300 million in 15-year with a coupon rate of respectively 4.51% and 4.95%.

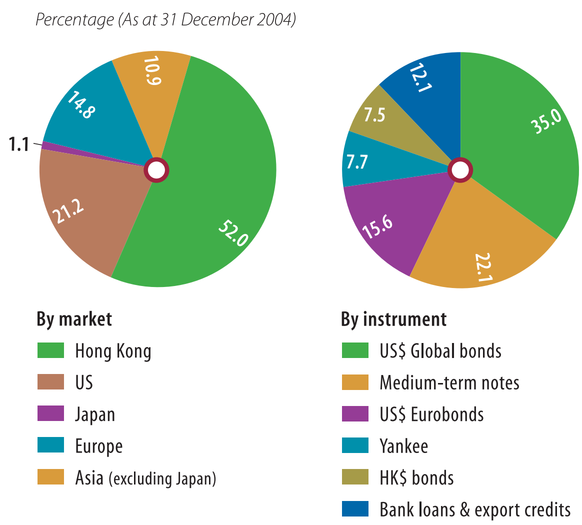
At the end of 2004, the Company had total undrawn committed facilities amounting to HK$5.8 billion which is sufficient to provide coverage for all of the Company's expected funding needs into the second quarter of 2006.

Cost of borrowing

The attractive terms of the new financings together with low interest rates prevailing during the year enabled the Group to reduce further our overall borrowing cost to 4.7% from 5.1% in 2003, resulting in a reduction of gross interest expense by HK$149 million.



Debt servicing capability
The Company's balance sheet strengthened with improved interest cover.



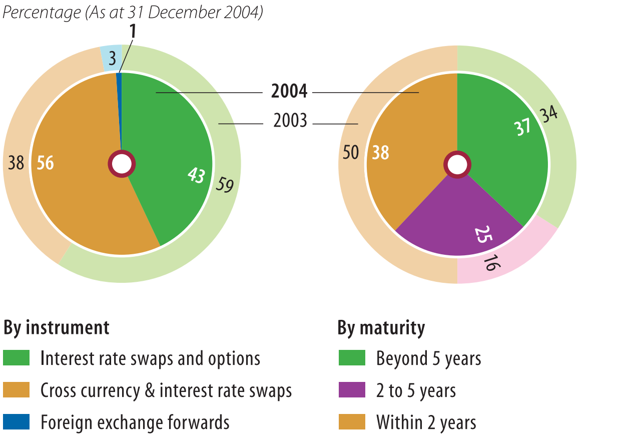
Sources of borrowing
While Hong Kong remains our main market, MTR continued to diversify its funding sources.

Risk management

We continued to undertake our fund raising activities and manage our debt portfolio in accordance with our well-established Preferred Financing Model, which seeks to achieve risk diversification by specifying the preferred mix of fixed and floating rate debts, permitted level of currency exposure, a well-balanced spread of maturities, use of different types of financing instruments in our debt portfolio, and an adequate financing horizon to cover future funding needs. As a result, the Company was able to maintain a balanced debt profile with adequate risk diversification and sufficient coverage of anticipated future funding needs.

The Company is one of the most active corporate users of derivative instruments in Hong Kong for managing the exposure of its debt portfolio to interest rate and currency risks. The Company's policy states that derivatives are used solely for hedging purposes and not for speculation, and that they are only to be transacted with counterparties with a credit rating of A-/A3 or better to control counterparty risk. In addition, the Company has long adopted a risk monitoring framework based on the widely accepted "value-at-risk" methodology and an "expected loss" concept to help further monitor and control counterparty risk exposure.

Percentage (As at 31 December 2004)



Use of interest rate and currency risk hedging products

MTR is an active user of derivatives, solely for hedging borrowing related interest rate and currency risks.

Credit ratings

The Company was the first Hong Kong corporate borrower to obtain internationally recognised credit ratings and has since maintained ratings on par with the Hong Kong Government due to our strong credit fundamentals, prudent financial management and continuous Government support.

In February, Moody's re-affirmed the Company's short-term foreign currency rating and long-term domestic/foreign currency ratings at respectively P-1 and Aa3/A1 with a stable outlook.

Standard & Poor's also affirmed our ratings at A-1+/A-1 and AA-/A+ for short-term local/foreign currency and long-term local/foreign currency borrowings respectively in April with a negative/stable outlook respectively on the local and foreign currency ratings. It subsequently revised our local currency ratings outlook from negative to stable in June following a similar change to Hong Kong's local currency sovereign ratings.

Credit ratings

	Short-term ratings*	Long-term ratings*
Standard & Poor's	A-1+/A-1	AA-/A+
Moody's	–/P-1	Aa3/A1
Rating and Investment Information Inc. (R&I)	a•1+/–	AA/AA-

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

In October, 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

During the year, we continued to use our well established and comprehensive long-term financial planning model based on widely accepted methodologies, to plan our railway operations and to evaluate new projects and investments. For new projects, the model subjects all investment proposals to a rigorous evaluation process that takes into account our weighted average cost of capital and a required rate of return, supplemented by necessary sensitivity tests on key variables. In addition, we carefully review all key assumptions used in the model periodically and as part of our annual budgeting exercise to ensure they are prudent and realistic, taking into account present business and economic conditions, and future likely changes. To manage our cost of capital effectively, we also undertake regular detailed assessment of our funding requirement and capital structure.

Financing capacity

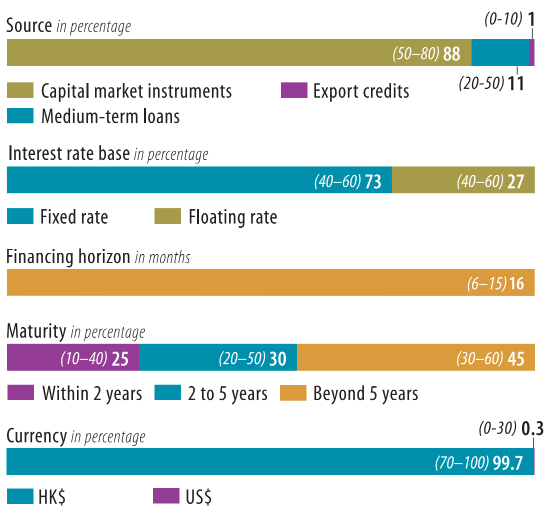
The Company's current committed capital expenditure programme comprises mainly the maintenance and upgrade of the existing lines, 50% land premium of Tseung Kwan O Area 86 Package One, and the construction of the Disneyland Resort Line and Tung Chung Cable Car, both of which are well advanced in construction towards their respective target completions in 2005 and 2006. Our committed capital expenditure programme for the three years between 2005 and 2007 is thus expected to be modest with a budget of around HK$6.8 billion.

This modest programme means that MTR will have sufficient financing capacity to take advantage of new investment opportunities as and when they arise, including those in the Mainland such as Shenzhen Line 4 and Beijing Line 4, for which we are negotiating the relevant agreements and seeking approvals from the various authorities, as well as those in Hong Kong such as the SIL and WIL extensions.

The estimated total investment of RMB 6 billion (HK$5.7 billion) for Shenzhen Line 4 will be funded by 40% equity and 60% non-recourse bank loans in Renminbi. MTR's investment in Beijing Line 4 will be represented by our 49% shareholding in the PPP company which is responsible for the trains and related electrical and mechanical systems which are estimated at RMB 5.0 billion (HK$4.7 billion). It is planned that more than 60% of the investment by the PPP company will be funded by non-recourse bank loans in Renminbi with the balance financed by equity capital. MTR's equity investment in the PPP company therefore is estimated at around RMB735 million (HK$693 million). We anticipate that MTR's total equity investment of slightly above RMB 3 billion (HK$2.8 billion) in these two projects will be financed by a combination of internally generated funds and external borrowing by the Company.

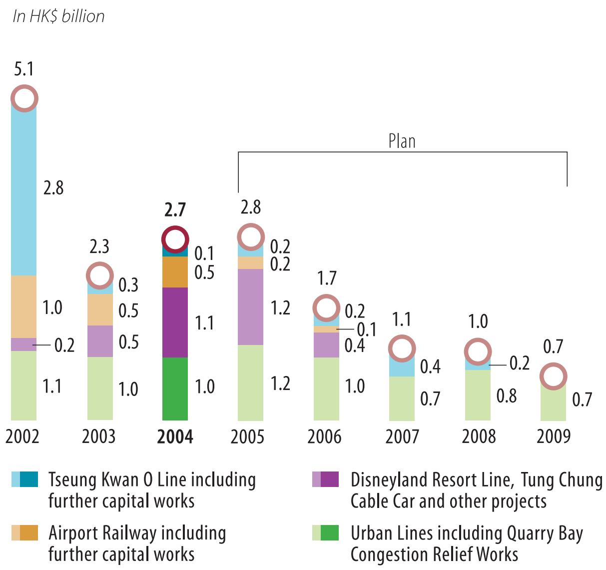
The capital structure and funding alternatives for the SIL and WIL as well as the Kwun Tong Line extension, in respect of which MTR submitted proposals to the Government, will be examined at a later stage if and when Government approvals are obtained.

(Preferred Financing Model) vs. **Actual debt profile**
As at 31 December 2004



Preferred financing model and debt profile

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



Investment in new railway lines and the existing network

The Company's capital expenditure increased in 2004, mainly due to construction of the Disneyland Resort Line.