

Report of the Members of the Board

The Members of the Board have pleasure in submitting their Report and the audited statement of Accounts for the financial year ended 31 December 2005.

Principal Activities of the Group

The principal activities of the Company and its subsidiaries are:

A the operation of a mass transit railway system with lines from Central to Tsuen Wan (Tsuen Wan Line), from Yau Ma Tei to Tiu Keng Leng (Kwun Tong Line), from Po Lam to North Point (Tseung Kwan O Line), from Chai Wan to Sheung Wan (Island Line), from Hong Kong to Tung Chung (Tung Chung Line), from Hong Kong to the Hong Kong International Airport and then AsiaWorld-Expo both at Chek Lap Kok (Airport Express Line) and from Sunny Bay to Disneyland Resort (Disneyland Resort Line);

B property development at locations relating to the railway system including the Tseung Kwan O Line Extension;

C related commercial activities, including the letting of advertising and retail space, bandwidth services on the railway telecommunication system, property management and leasing management of investment properties (including shopping centres and offices), property agency and Octopus Card Building Access System services;

D the construction, commissioning and opening of Disneyland Resort Line and AsiaWorld-Expo Station beyond Airport Station as an extension of the Airport Express Line;

E the design and construction of the Ngong Ping 360 tourism facilities and subsequent monitoring of the appointed operator;

F the planning and construction of future extensions to the railway system and other related infrastructure projects;

G consultancy services covering all areas of expertise required in the project management, planning, construction, operation, maintenance and up-grading of railways plus fare collection, property integration/development advice including other property related services and advice on generation of non-fare revenues;

H investment in Octopus Holdings Limited, a subsidiary of the Company, which has business activities both in Hong Kong and overseas including the operation of a smart card system by its subsidiary Octopus Cards Limited for the collection of payments for both transport and non-transport applications in Hong Kong;

I equity investments and long term operation and maintenance contracts outside of Hong Kong;

J property management, shopping centre investment and railway related property development business in China; and

K the investment in, and construction of, Beijing Metro Line 4, in which the Company has a 49% equity interest, for future operations under a 30-year concession agreement with the Beijing Municipal Government.

In addition to the above, a Feasibility Study Report for Shenzhen Line 4 has been submitted to National Development and Reform Commission for approval. The Company is waiting for the result.

Dividend

The Directors have recommended a final dividend of HK\$0.28 per Ordinary Share to be payable to shareholders whose names appear on the Register of Members of the Company on 11 April 2006.

Subject to the passing of the necessary resolutions at the forthcoming Annual General Meeting, such dividend will be payable on or about 27 June 2006, in cash in Hong Kong dollars, with a scrip dividend alternative. The Company's majority shareholder, The Financial Secretary Incorporated, has agreed to elect 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 in the form of cash.

Members of the Board

Members of the Board who served during the year were Raymond Ch'ien Kuo-fung (non-executive Chairman), Chow Chung-kong (Chief Executive Officer), Cheung Yau-kai, David Gordon Eldon, Christine Fang Meng-sang, Edward Ho Sing-tin, Lo Chung-hing, T. Brian Stevenson, Frederick Ma Si-hang, the Secretary for the Environment, Transport and Works (Sarah Liao Sau-tung) and the Commissioner for Transport (Robert Charles Law Footman ceased to hold the post of the Commissioner for Transport and Alan Wong Chi-kong was appointed to that post, both with effect from 18 June 2005).

At the Annual General Meeting on 2 June 2005 and pursuant to the Articles of Association, Cheung Yau-kai, Edward Ho Sing-tin and Lo Chung-hing retired under the Articles of Association and were re-elected as Members of the Board.

At the forthcoming Annual General Meeting and in accordance with the Articles of Association, Raymond Ch'ien Kuo-fung, T. Brian Stevenson and Frederick Ma Si-hang will retire by rotation. All these three Board Members will offer themselves for re-election at that Meeting.

Biographical details for Board Members are set out on pages 66 to 68.

Alternate Directors

The Alternate Directors in office during the year were (i) Martin McKenzie Glass and Alan Lai Nin (both for Frederick Ma Si-hang), (ii) both the Permanent Secretary for the Environment, Transport & Works (Joshua Law Chi-kong) and the Deputy Secretary for the Environment, Transport & Works (Patrick Ho Chung-kei, Thomas Chow Tat-ming, Cathy Chu Man-ling and Annie Choi Suk-han) (for the Secretary for the Environment, Transport & Works), and (iii) the Deputy Commissioner for Transport/Transport Services and Management (Judy Li Wu Wai-lok [who ceased to be the Deputy Commissioner for Transport/Transport Services and Management and accordingly ceased to be the alternate director for the Commissioner for Transport] and Carolina Yip Lai-ching [with effect from 23 May 2005]) (for the Commissioner for Transport).

Executive Directorate

The Members of the Executive Directorate who served during the year were Chow Chung-kong (Chief Executive Officer and a Member of the Board), Russell John Black, William Chan Fu-keung, Philip Gaffney [retired with effect from 5 December 2005], Thomas Ho Hang-kwong, Lincoln Leong Kwok-kuen, Francois Lung Ka-kui [appointed with effect from 26 September 2005], Andrew McCusker [appointed with effect from 1 October 2005] and Leonard Bryan Turk.

Biographical details for Members of the Executive Directorate during the year are set out on pages 69 and 70.

Internal Audit

The Company's Internal Audit Department provides independent, objective assurance and consulting services designed to add value and improve the Company's operations. Key responsibilities of the Department include:

- Assessments on the adequacy and effectiveness of the Company's system of internal control for controlling its activities and managing its risks.

- Identification of opportunities for improving management control, resources utilisation and profitability.

- Special reviews and/or investigations as commissioned by Company management.

The Company's Internal Auditor reports directly to the Chief Executive Officer and has direct access to the Audit Committee.

Business Ethics

Please refer to page 62.

Policies

The Board has adopted risk management strategies on the following matters:

- A** Construction and insurance;
- B** Finance;
- C** Treasury risk management;
- D** Safety risk management;
- E** Security management.

No changes to such policies may be made without the approval of the Board.

Public Float

The Stock Exchange granted to the Company, at the time of its listing on the Main Board of the Stock Exchange in 2000, a waiver from strict compliance with Rule 8.08(1) of the Listing Rules ("Public Float Waiver"). Pursuant to the Public Float Waiver, the Company's prescribed minimum percentage of shares which must be in the hands of the public must not be less than 10% of the total issued share capital of the Company. Based on the information that is publicly available to the Company and within the knowledge of the Directors, the Company has maintained the prescribed amount of public float during the year and up to the date of this report as required by the Public Float Waiver.

Bank Overdrafts, Bank Loans and Other Borrowings

The total borrowing of the Group as at 31 December 2005 amounted to HK\$28,264 million (2004: HK\$30,378 million). Particulars of borrowings including bank overdrafts and bank loans are set out in note 33 to the accounts.

Accounts

The state of affairs of the Company and the Group as at 31 December 2005 and of the Group's results, changes in equity and cash flows for the year are set out in the accounts on pages 83 to 163.

Ten-Year Statistics

A summary of the results and of the assets and liabilities of the Group together with some major operational statistics for the last ten years are set out on pages 52 and 53.

Fixed Assets and Railway Construction in Progress

Movements in fixed assets and railway construction in progress during the year are set out in notes 17 and 18 to the accounts respectively.

Movements in Reserves

Movements in reserves during the year are set out in notes 40 and 41 to the accounts.

Share Capital

As at 31 December 2004, the authorised share capital of the Company was HK\$6.5 billion, divided into 6.5 billion Ordinary Shares, 5,389,999,974 of which were issued and credited as fully paid. During the year, the Company issued a total of 91,856,465 Ordinary Shares. Of this number:

A 5,282,500 Ordinary Shares were issued by the Company pursuant to the exercise of share options which had been granted under the Company's Pre-Global Offering Share Option Scheme (as referred in note 40 to the accounts). In respect of each Ordinary Share issued, the relevant exercise price per share of options is HK\$8.44 to the Company;

B 117,500 Ordinary Shares were issued by the Company pursuant to the exercise of share options which had been granted under the Company's New Joiners Share Option Scheme (as referred in note 40 to the accounts). In respect of each Ordinary Share issued, the relevant exercise price per share of options is HK\$9.75, HK\$15.75, HK\$15.97 and HK\$16.05 respectively;

C 62,121,448 Ordinary Shares were issued by the Company in order to satisfy shareholders' scrip dividend elections in respect of the final dividend of the Company for the year ended 31 December 2004 (for which the cash dividend was HK\$0.28 per Ordinary Share); and

D 24,335,017 Ordinary Shares were issued by the Company in order to satisfy shareholders' scrip dividend elections in respect of the interim dividend of the Company for the six months ended 30 June 2005 (for which the cash dividend was HK\$0.14 per Ordinary Share).

As at 31 December 2005, the authorised share capital of the Company was HK\$6.5 billion, divided into 6.5 billion Ordinary Shares, 5,481,856,439 of which were issued and credited as fully paid.

Redemption of Listed Securities

Neither the Company nor any of its subsidiaries purchased, sold or redeemed any of its listed securities during the financial year 2005.

Properties

Particulars of the principal investment properties and properties held for sale of the Company are shown on page 37.

Donations

During the year, the Company donated a total of HK\$1,065,332 to charitable organisations. In early 2005, the Company donated HK\$860,000 for the relief work of the South Asia Tsunami and made available its stations and shopping malls to charities and raised over HK\$1.2 million aiding this cause.

Reporting and Monitoring

There is a comprehensive budgeting system for all operational and business activities, with an annual budget approved by the Board. Monthly results of the Company's operations, businesses and projects are reported against the budget to the Board and updated forecasts for the year are prepared regularly.

Treasury Management

The Company's Treasury Department operates within approved guidelines from the Board. It manages the Company's debt profile with reference to the Preferred Financing Model which defines the preferred mix of financing instruments, fixed and floating rate debts, maturities, interest rate risks, currency exposure and financing horizon. The model is reviewed and refined periodically to reflect changes in the Company's financing requirements and market environment. Derivative financial instruments such as interest rate swaps and cross currency swaps are used only as hedging tools to manage the Group's interest rate and currency risks. Prudent guidelines and procedures are in place to control the Company's derivatives activities, including a comprehensive credit risk management system for monitoring counterparty credit exposure using the Value-at-Risk approach. There is also appropriate segregation of duties within the Company's Treasury Department.

Major financing transactions and guidelines for derivatives transactions including credit risk management framework are approved at the Board level.

Capital and Revenue Expenditure

There are defined procedures for the appraisal, review and approval of major capital and revenue expenditures. All project expenditure over 0.2% of the net assets of the Company and the employment of consultancy services over 0.1% of the net assets of the Company require the approval of the Board.

Bonds and Notes Issued

The Group issued bonds and notes during the year ended 31 December 2005, details of which are set out in note 33D to the accounts. Such bonds and notes were issued in order to meet the Group's general corporate funding requirements, including the financing of new capital expenditure and the refinancing of maturing debts.

Computer Processing

There are defined procedures and regular quality reviews on the operation of computer systems to ensure the accuracy and completeness of financial records and efficiency of data processing. The Company's computer centre and help desk operation and

support, and also software development and maintenance, have been certified under ISO 9001:2000. Disaster recovery rehearsal on critical applications is conducted annually.

Interests in Contracts of Members of the Board and the Executive Directorate

There was no contract of significance, to which the Company or any of its subsidiaries was a party and in which a Member of the Board or a Member of the Executive Directorate had a material interest (whether direct or indirect), which subsisted at the end of the year or at any time during the year.

Board Members' and Executive Directorate's Interests in Shares

As at 31 December 2005, the interests or short positions of the Members of the Board and the Executive Directorate in the shares, underlying shares and debentures of the Company (within the meaning of Part XV of the Securities and Futures Ordinance ("SFO")) as recorded in the register required to be kept under section 352 of the SFO or as otherwise notified to the Company and the HKSE pursuant to the Model Code were as follows:

Long Positions in Shares and Underlying Shares of the Company

Member of the Board or Executive Directorate	Number of Ordinary Shares held			Derivatives		Total interests	Percentage of aggregate interests to total issued share capital
	Personal* interests	Family [†] interests	Corporate interests	Share Options	Other		
Chow Chung-kong	–	–	–	–	700,000 (Note 1)	700,000	0.01277
T. Brian Stevenson	4,585	–	–	–	–	4,585	0.00008
Christine Fang Meng-sang	1,675	–	–	–	–	1,675	0.00003
Russell John Black	52,778	–	–	–	–	52,778	0.00096
William Chan Fu-keung	46,233	–	–	317,500 (Note 2)	–	363,733	0.00664
Thomas Ho Hang-kwong	52,696	2,524	–	321,000 (Note 2)	–	376,220	0.00686
Lincoln Leong Kwok-kuen	23,000	–	23,000 (Note 3)	1,043,000 (Note 4)	–	1,089,000	0.01987
Francois Lung Ka-kui	–	–	–	1,066,000 (Note 4)	–	1,066,000	0.01945

Notes

1. Chow Chung-kong has a derivative interest in respect of 700,000 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 700,000 shares in the Company on completion of his three-year contract (on 30 November 2006).

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.

* 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, as referred to in Notes 7B (i) and 42A (i) to the Accounts

Executive Directorate and eligible employees	Date granted	No. of options granted	Period during which rights exercisable (day/month/year)	Options outstanding as at 1 January 2005	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 31 December 2005	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	317,500	–	–	–	8.44	317,500	–
Thomas Ho Hang-kwong	20/9/2000	1,066,000	5/4/2001 – 11/9/2010	321,000	–	–	–	8.44	321,000	–
Other eligible employees	20/9/2000	41,409,000	5/4/2001 – 11/9/2010	16,567,500	–	–	5,282,500	8.44	11,285,000	13.68

Notes

1. The Pre-Global Offering Share Option Scheme ("Pre-IPO Option Scheme") shall be valid and effective for a period of ten years after the adoption of the Pre-IPO Option Scheme on 12 September 2000. No option may be offered to be granted on or after the commencement of dealings in shares of the Company on HKSE on 5 October 2000.

2. The number of shares to which the option granted to each participant under the Pre-IPO Option Scheme does not exceed 25% of the number of the shares issued and issuable under the Pre-IPO Option Scheme.

Options to subscribe for Ordinary Shares granted under the New Joiners Share Option Scheme, as referred to in Notes 7B (ii) and 42A (ii) to the Accounts

Executive Directorate and eligible employees	Date granted	No. of options granted	Period during which rights exercisable (day/month/year)	Options outstanding as at 1 January 2005	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 31 December 2005	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	1,066,000	355,500	–	23,000	9.75	1,043,000	14.10
Francois Lung Ka-kui	27/9/2005	1,066,000	26/9/2006 – 26/9/2015	–	–	–	–	15.75	1,066,000	–
Other eligible employees	1/8/2003	495,200	14/7/2004 – 14/7/2013	495,200	165,500	–	94,500	9.75	400,700	15.40
	13/9/2005	94,000	9/9/2006 – 9/9/2015	–	–	–	–	15.97	94,000	–
	23/9/2005	213,000	9/9/2006 – 9/9/2015	–	–	–	–	15.97	213,000	–
	17/10/2005	94,000	6/10/2006 – 6/10/2015	–	–	–	–	16.05	94,000	–

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 ("New 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 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.

Save as disclosed above:

A none of the Members of the Board or Executive Directorate of the Company 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 during the year ended 31 December 2005, no Member of the Board or Executive Directorate 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.

Directors' Service Contracts

No director proposed for re-election at the forthcoming Annual General Meeting has a service contract which is not determinable by the Company or any of its subsidiaries within one year without payment of compensation, other than statutory compensation.

No Director has a service contract with the Company or any of its subsidiaries which is for a duration which may exceed three years or which requires the Company to, in order to terminate such contract, give a notice period in excess of one year or pay or make other payments equivalent to more than one year's emoluments.

Substantial Shareholders' Interests

Set out below is the name of the party which was interested in 5% or more of the nominal value of the share capital of the Company and the respective relevant numbers of shares in which it was interested as at 31 December 2005 as recorded in the register kept by the Company under section 336 of the SFO:

Name	No. of Ordinary Shares	Percentage of Ordinary Shares to total issued share capital
The Financial Secretary Incorporated (in trust on behalf of the Government)	4,195,703,166	76.54

The Company has been informed by the Government that, as at 31 December 2005, approximately 1.49% of the shares of the Company 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.

Loan Agreements with Covenant Relating to Specific Performance of the Controlling Shareholder

As at 31 December 2005, the Group had borrowings of HK\$28,003 million with maturities ranging 2006 to 2020 and undrawn committed and uncommitted banking and other facilities of HK\$10,139 million, which were subject to the condition that the Government, being the Company's controlling shareholder, owns more than half in nominal value of the voting share capital of the Company during the lives of the borrowings and the undrawn facilities. Otherwise, immediate repayment of borrowings may be demanded and cancellation of the undrawn facilities may result.

Major Suppliers and Customers

Less than 30% in value of supplies (which were not of a capital nature) purchased during the year ended 31 December 2005 was attributable to the Company's five largest suppliers. Less than 30% in value of the Company's turnover during the year ended 31 December 2005 was attributable to the Company's five largest customers combined by value.

Going Concern

The accounts on pages 83 to 163 have been prepared on a going concern basis. The Board has reviewed the Company's budget for 2006, together with the longer-term forecast for the following five years and is satisfied that the Company has sufficient resources to continue as a going concern for the foreseeable future.

Connected Transactions

During the year under review the following transactions and arrangements described below have been entered into (or were ongoing) with persons who are "connected persons" for the purposes of the Listing Rules:

Land Agreements

A (a) New Grant No. 9689 dated 16 May 2002, of Tseung Kwan O Town Lot No. 70 for development at Tseung Kwan O Area 86 (building covenant period expiry date 31 December 2015 or 60 months from the due date for payment of land premium of Site O, whichever is the later, which was extended to 31 December 2018 or 66 months from the due date for payment of land premium of Site O, whichever is the later, pursuant to the Further Modification Letter described in B below) with a total consideration or value of HK\$150,000,000 for site M1 and the consideration for the other sites to be assessed.

(b) The Company entered into a Modification Letter dated 19 April 2005 (the "Modification Letter") with Government for determining the building covenant period expiry date of Site F as 30 June 2011 and other development parameters for Site F with a total consideration or value of HK\$2,319,290,000.

B Following the end of the year under review, the Company accepted on 18 January 2006 an offer from Government to proceed with the proposed development of Site AB of Tseung Kwan O Town Lot No. 70, Area 86, Tseung Kwan O, Sai Kung, New Territories, subject to (a) the Company's acceptance of Government's assessment of the premium for Site AB (as defined below) and of the terms of a further modification letter ("Further Modification Letter") to be entered into between the Company and Government in relation to the particulars and conditions for the grant of an agreement for lease by private treaty of Tseung Kwan O Town Lot No. 70 between the Government and the Company dated 16 May 2002 as varied or modified by the Modification Letter, and (b) ancillary terms and conditions.

It is proposed that the original Site A and Site B of Tseung Kwan O Town Lot No. 70 will be amalgamated into one site to be renamed "Site AB". The Further Modification Letter fixes the boundary of Site AB, defers the expiry dates of the building covenant periods, revises the requirements relating to the Government accommodation, requires the Company to make payments in respect of noise mitigation measures and sets out the development parameters. The entire site area of Tseung Kwan O Town Lot No. 70 is approximately 326,751 square metres and the total gross floor area of the development on Site AB will be not less than 185,818 square metres and not more than 309,696 square metres. The Company is required to pay to the Government the premium for Site AB, which was assessed by the Valuation Section of the Lands Department of the Government to be HK\$8,061,470,000, by reference to the full market value of Site AB, ignoring the presence of the railway. The value of Site AB, by reference to the premium assessed, was HK\$8,061,470,000 as at 18 January, 2006. The Company is required to pay the premium for Site AB in one lump sum within 3 calendar months from 18 January, 2006. The premium will be paid by the developer of Site AB, namely Rich Asia Investments Limited.

The Company has accepted Government's offer and has executed relevant documentation and proposes to execute the Further Modification Letter in order to be allowed to proceed with the proposed development on Site AB.

As the Government is a controlling shareholder of the Company and therefore a connected person of the Company, the transaction is also a connected transaction for the Company under Rule 14A.13 of the Listing Rules. As disclosed in the announcement of the Company dated 13 January, 2005, the Stock Exchange has granted a waiver to the Company from strict compliance with the requirements under Chapter 14A of the Listing Rules which would otherwise apply to connected transactions between the Company and the Government, subject to certain conditions (the "Waiver").

C In respect of the Remaining Portion of Mass Transit Railway Lot No. 1:

A Supplemental Lease was signed on 11 February 2002 between Government and the Company in which the Government leased to the Company land occupied by the Quarry Bay Congestion Relief Works or the Quarry Bay Relief Works connecting Quarry Bay Station to North Point Station at an annual rent of 3% of the rateable value of the leased area for a term commencing 1 October 2001 to 29 June 2050 on terms and conditions substantially similar to the lease for the Mass Transit Railway Lot No. 1. By a Modification Letter dated 13 May 2002 entered into between Government and the Company, the lease for the Remaining Portion of Mass Transit Railway Lot No. 1 was modified in areas indicated in the lease plans attached to the Modification Letter at an administration fee of HK\$16,200. By a Modification Letter dated 20 December 2003 entered into between the Government and the Company, the lease for the Remaining Portion of Mass Transit Railway Lot No. 1 was modified in areas indicated in the lease plans attached to the Modification Letter in the consideration of a premium of HK\$1,000 and an administration fee of HK\$16,200. By a Modification Letter executed by the Government and the Company dated 31 May 2004, the lease for the Remaining Portion of Mass Transit Railway Lot No. 1 was modified in areas indicated in the lease plans attached to the Modification Letter in the consideration of a premium of HK\$1,000 and an administrative fee of HK\$16,200. By a modification letter dated 1 March 2005 entered into between Government and the Company, the lease for the Remaining Portion of Mass Transit Railway Lot No. 1 was modified in areas indicated in the lease plans attached to the Modification Letter in the consideration of a premium of HK\$1,000 and an administrative fee of HK\$16,200.

Adjustment of Arrangements Relating to Octopus Cards Limited

On 21 October 2005, the Company and, inter alios, other shareholders of Octopus Cards Limited ("Octopus Cards"), namely Kowloon-Canton Railway Corporation ("KCRC"), KMB Public Bus Services Holdings Limited ("KMB"), Citybus Limited ("Citybus") and New World First Bus Services Limited ("NWFB"), entered into a Sale and Purchase Agreement with Octopus Holdings Limited ("OHL") for the sale of the entire issued share capital of Octopus Cards to OHL, in consideration of the issuance and allotment of shares in the capital of OHL to each of the former shareholders of Octopus Cards with the result that the direct shareholding interests of Octopus Card's former shareholders in Octopus Cards are the same as their current indirect shareholding interests in Octopus Cards held through OHL.

On 21 October 2005, the Company and, inter alios, other shareholders of OHL, namely KCRC, KMB, Citybus and NWF, entered into a Shareholders' Agreement in respect of arrangements regarding OHL, such as the ownership, management and operation of OHL and its subsidiaries (including but not limited to Octopus Cards).

On 21 October 2005, the Company and, inter alios, other shareholders of OHL, namely KCRC, KMB, Citybus and NWF, entered into a Subordinated Loan Agreement with OHL providing finance to OHL by way of a shareholders' loan in the aggregate amount of HK\$150 million made by each shareholder of OHL in proportion to their respective shareholdings in OHL which shall rank as subordinated debt. The Company has therefore lent HK\$86.1 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. The loan was effectively funded by a dividend payment from Octopus Cards to its shareholders, which was then loaned back to OHL. Octopus Cards then transferred the entire issued share capital of one of its wholly owned subsidiaries, Octopus Netherlands Limited, to Octopus Knowledge Limited, a wholly owned subsidiary of OHL to set up for all international consultancy activities.

The purpose of the above restructuring is to spin off the non-payment business of Octopus Cards into new, separate subsidiaries independent of the payment business of Octopus Cards that is regulated by the Hong Kong Monetary Authority. To effect these adjustments ("Adjustments"), a new holding company, OHL, was interposed between Octopus Cards and its former shareholders to hold the entire issued share capital of each of these new companies as well as Octopus Cards. The economic substance of the relationship between the shareholders of Octopus Cards has not changed as a result of the Adjustments, other than the fact that their interests in Octopus Cards have become indirect instead of direct. No other benefits are expected to accrue to the Company as a result of the Adjustments.

In accordance with paragraph (B)(II)(i) of the Waiver, the Company confirms that the Adjustments were entered into:

- (a) in the ordinary and usual course of its business;
- (b) on terms that are, in the opinion of the Board of Directors, fair and reasonable and in the interests of the shareholders of the Company as a whole; and

(c) on terms no less favourable than terms available to the other shareholders of Octopus Cards.

As KCRC and KMB are both substantial shareholders of a subsidiary of the Company (namely, Octopus Cards), and Octopus Cards is a non wholly owned subsidiary of the Company where KCRC and KMB are each entitled to exercise 10% or more of the voting power at any general meeting of Octopus Cards, and, further, the Government is a substantial shareholder of the Company and KCRC is wholly owned by the Government, each of KCRC, KMB and Octopus Cards is therefore a connected person of the Company and the Adjustments described above involve connected transactions for the Company under Rule 14A.13 of the Listing Rules. To the best of the Directors' knowledge, information and belief having made all reasonable enquiry, all of the other counterparties and their ultimate beneficial owners are third parties independent of the Company and connected persons of the Company.

An announcement on the above Adjustments was made on 25 October 2005 in accordance with the conditions of the Waiver. The above disclosure relating to the Adjustments is made in accordance with the conditions of the Waiver and Rule 14A.45 of the Listing Rules.

Continuing Connected Transactions

On 30 June 2005, the Company entered into a supplemental agreement with The Hong Kong Airport Authority ("AA") ("Supplemental Agreement") for the renewal for a further three-year period of the existing maintenance agreement for the Automated People Mover at Hong Kong International Airport (the "Airport").

The Company entered into the original maintenance agreement (the "Maintenance Agreement") with the AA on 18 March 2002. The Maintenance Agreement was for a term of three years, which expired on 6 July 2005. However, the Maintenance Agreement also included an option, exercisable at the discretion of the AA, to extend the term of the agreement at pre-agreed rates and prices for another three years until 6 July 2008.

Since entering into the Maintenance Agreement, the AA has decided to modify and extend the Automated People Mover in order to serve the new Sky Plaza and Sky Pier terminal buildings which are being built at the Airport. This has correspondingly extended the scope of maintenance work for the Automated People Mover. As a result, the price for the option to extend the Maintenance Agreement for a further three-year period has been re-negotiated and reflected in the Supplemental Agreement. Otherwise, the basic terms and conditions of the Maintenance Agreement have not been changed.

The AA, being an associate (as defined in the Listing Rules) of Government, a substantial shareholder of the Company, is a connected person of the Company. As the Supplemental Agreement is a transaction between the Company and a connected person (i.e. the AA) (the "Transaction"), it constitutes a connected transaction for the Company. In addition, on the basis that the agreement involves the provision of services on an ongoing basis, the Supplemental Agreement constitutes a continuing connected transaction for the Company. The transaction is subject to the terms of the Waiver.

The above disclosure relating to the Transaction is made in accordance with paragraph (B)(l)(i) of the Waiver and Rule 14A.46 of the Listing Rules.

In accordance with paragraph (B)(l)(iii)(a) of the Waiver, all the Independent Non-executive Directors of the Company have reviewed the Transaction and confirmed that the Transaction was entered into :

- (1) in the ordinary and usual course of the business of the Company;
- (2) on normal commercial terms which are no less favourable to the Company than terms available from independent third parties; and
- (3) in accordance with the Maintenance Agreement and the Supplemental Agreement on terms that are fair and reasonable and in the interests of the shareholders of the Company as a whole.

The Company has engaged the auditors of the Company to carry out a review of the Transaction in accordance with Hong Kong Standard on Related Services 4400 "Engagements to Perform Agreed-Upon Procedures Regarding Financial Information" issued by the Hong Kong Institute of Certified Public Accountants. In accordance with paragraph (B)(l)(iii)(b) of the Waiver, the auditors have confirmed to the Board of Directors that the Transaction :

- (i) has been approved by the Members of the Board of the Company; and
- (ii) has been entered into in accordance with the terms of the Maintenance Agreement, as amended by the Supplemental Agreement.

Project Agreement

On 28 December 2005, the Company entered into a supplemental agreement to the project agreement dated 4 November 1998 for the design, construction, financing and operation of the Tseung Kwan O Extension (the Principal Agreement) with Government to amend the ultimate stabling capacity of the Tseung Kwan O Depot in Area 86 as stated in the Principal Agreement, in consideration of the Company's undertakings to bear all costs and consequences associated with future changes in the stabling arrangements for extensions covered under the Principal Agreement.

Government is a substantial shareholder in the Company.

Auditors

The retiring auditors, KPMG, have signified their willingness to continue in office. A resolution will be proposed at the Annual General Meeting to reappoint them and to authorise the Directors to fix their remuneration.

By order of the Board

Leonard Bryan Turk
Secretary to the Board
Hong Kong, 7 March 2006