

Railway operations

Fare revenue from MTR Lines and Airport Express for 2006 increased 3.8% to HK\$6,523 million, driven higher by passenger growth from economic expansion, the full-year impact of the opening of Disneyland Resort Line (DRL) and the AsiaWorld-Expo (AWE) Station, and higher average fares from MTR Lines.

Patronage

Total patronage on MTR Lines rose 1.0% to a record 867 million and average weekday patronage increased 1.0% to 2.5 million. Our share of the total franchised public transport market remained stable at 25%, while cross-harbour market share was also stable at 61%. Fare revenue increased 3.3% to HK\$5,911 million.

Airport Express' passenger volume rose 12.8% to 9.6 million. Average daily patronage rose 12.8% to 26,200, and Airport Express' estimated market share rose to 23% from 22%. Fare revenue increased 9.1% to HK\$612 million.

Service promotions

One of our strengths is the effectiveness of our promotions. A "Ride 10 Redeem Hello Kitty Stamps" promotion generated 1.2% additional patronage and contributed extra income as the stamps became collectible items. In May, we launched the Happy Index Promotion, attracting over 20,000 daily users. Two TV projects were also launched – a game show and comedy sponsorship, jointly produced with TVB Jade. These programmes helped reinforce positive customer service perceptions.

We regularly conduct MTR Club surveys to solicit suggestions and opinions. We treasure club members' input and advice as they are long term supporters of our service.

On Airport Express, the increasingly popular "Ride to Rewards" loyalty programme was enhanced with the additional option of award points from Dragonair VISA. To attract more local leisure travellers, fare promotions were offered during festive seasons. Overseas passengers were offered fare discounts on tourist products through a partnership with the Hong Kong Tourism Board and the UnionPay Discover Hong Kong Club. An advertising campaign also helped increase awareness of the newly opened AWE Station.

Promoting patronage on MTR Lines through improved connectivity with other modes of transport helps maintain market share. Seven more feeder bus routes offering inter-modal fare discounts were added, bringing the number to 32 in total. We also introduced four new fare saver machines to offer fare incentives to adult Octopus card holders, resulting in a total of 20 in service by the end of 2006.

Our marketing and branding efforts attracted high-profile awards, including the "Top Ten Most Popular TV Commercials Award" and "Most Impressive TV Commercial" in the ATV-hosted 12th Annual Most Popular TV Commercial awards, "Prime Awards for Brand Excellence 2006 – Transport Services" awarded by *Prime Magazine*, and the "Hong Kong Brands – Classic" award jointly presented by *East Week* magazine and Sing Tao Publishing.

Service performance

For the sixth consecutive year, we exceeded both the minimum performance levels under the Operating Agreement and our more stringent Customer Service Pledges. Passenger journeys on time for MTR Lines were 99.9%, supported by 99.9% reliability for train service delivery and 99.7% train punctuality.

To improve passenger service further, "Year of the Customer" and "We serve from the heart" campaigns were launched, supported by training for our station staff and platform assistants. There were also elections for Best Station Operators and other campaigns targeting escalator and train door safety.

Customer satisfaction levels remained high. In 2006, the Service Quality Index for the MTR Lines and Airport Express stood at 71 and 81 respectively on a 100-point scale. We also continued to rank high in the

international benchmarking exercise performed by the 12-member Community of Metros. Service performances again received widespread recognition. We won *East Week* magazine's "Quality Living Award HK 2006" – Public Transport Category and, for the eighth consecutive year, *Next Magazine's* "Top Service Award 2006" – Public Transport Category.

To ensure continued excellence and effectiveness of safety delivery and meet the requirements of the Operating Agreement, our fifth External Safety Management System Review was undertaken by the American Public Transportation Association. Results revealed that 8 of our safety practices are considered "industry leading effective practices" and 141 "industry effective practices". The review concluded that the Company not only fulfilled internal and industry safety requirements, but is also in many areas a leader in safety management among rail operators worldwide.

Service improvements

Train services and network infrastructure improvements continued.

The programme to retrofit platform screen doors at all 74 platforms in underground stations finished in the first half of 2006, ending a six-year project. The station improvement programme continued, with 38 stations undergoing improvements and renovations, bringing the number of renovated stations to 46 since the programme started in 1998.

Enhancements were made to passenger information systems in stations and on trains. On the Tung Chung Line, information about the time to the next train was extended, while on Airport Express trains a multi-media system with audio facilities embedded in seat headrests was rolled out. The network's public announcement system and passenger information displays were reconfigured to improve timely release of information.

In January, a rail replacement programme to upgrade the rail infrastructure in the Kwun Tong and Tsuen Wan lines was launched to improve ride quality and service reliability.

Access to the network was improved through completion of new pedestrian links at three stations.

Since September, the frequency of Tung Chung Line trains during peak periods and non-peak hours has been enhanced. By year end, a total of three new trains had been commissioned. The replacement of motor alternators on the 78 trains on MTR Lines by state-of-the-art static inverters was substantially completed. The inverters improve energy efficiency and reliability, and reduce noise.

Station improvements promoting barrier free movement for passengers continued. A new escalator audible device that assists visually impaired passengers was introduced at four stations, and a new induction loop that helps hearing impaired passengers was installed at all stations along the Tung Chung Line and Airport Express. The installation of internal passenger lifts is underway at Lai Chi Kok and Tai Wo Hau stations, while self-operated stair lift installations are underway at seven stations, which will be completed in 2008.

In September we introduced an innovative application of nano silver-titanium dioxide coating to improve hygiene levels in MTR. This powerful non-toxic disinfectant has been applied to commonly touched surfaces in MTR stations, trains and shopping malls. The project was completed in December.

Productivity

The Company continued to examine ways to improve efficiency and productivity. Operating costs per car kilometre decreased 3.1% to HK\$22.1. Maintenance costs were successfully contained, even though the full-year effect of the opening of DRL and the AWE Station resulted in a 3% increase in total revenue car kilometres operated in 2006. Corporate support costs also fell.

Our maintenance information system was upgraded to the Enterprise Asset Management System, enabling us to optimise operational effectiveness and improve asset utilisation and performance.

Station commercial and other businesses

Revenue from the Company's station commercial and other businesses increased by 3.3% to HK\$1,606 million in 2006. Excluding a one-off gain from a telecommunications contract in 2005 and a similar one-off item in 2006, revenue would have increased by 8.0%. The increase was supported by the strong economy and a contribution from Ngong Ping 360.

Advertising

Advertising revenue rose 4.7% to HK\$534 million. The Company continued to enhance the attractiveness of its advertising venues through format refinements and innovation, although the growth of the advertising market slowed in the second half of 2006.

Among new formats introduced, Real Time Projection Zones were introduced at eight MTR stations. June saw the debut of the "Spectacular Mobile Showcase" advertising train. New 6-sheet scrolling units were introduced at Causeway Bay and Kowloon Tong stations.

The number of trackside plasmas increased from 68 to 100 units by year end and three new plasma rings were installed at stations. The Concourse Plasma Network was upgraded to provide real time updates on the Hang Seng Index.

On the Airport Express, the seatback TV was replaced by a multimedia system offering more information and entertainment, and more creative media for advertisers. A free infotainment magazine, "metropop", was launched in April.

In February, we launched a service allowing CLP Power customers to pay their bills at Customer Services Centres.

Telecommunications

Revenue from telecommunications services decreased by 22.5% to HK\$259 million. Excluding the one-off items in 2005 and 2006 mentioned earlier, revenue would have decreased by 3.2%.

Migration of mobile subscribers from 2G to 3G and intense competition meant 2G call minutes and revenue declined. However, other telecommunications business, such as rooftop site rentals, grew.

Market expansion led to higher revenue for TraxComm Limited, whose optical fibre network now covers 40 locations, with bandwidth capacity of over 180 Gbps.

Station commercial

Revenue from station retail shops benefited from higher rental rates, which offset a temporary net loss of retail space, to rise by 13.7% over 2005 to HK\$391 million.

Retail zone renovations were completed at 11 stations. A total of 468 square metres of new retail area was added due to renovation, but the temporary loss of 2,671 square metres at Kowloon Station to facilitate station integration works with the new shopping centre Elements, resulted in the total station retail area decreasing 12% to 16,867 square metres. In all, 32 new shops and 15 new trades or brands were added to the station retail network.

We also expanded cross selling promotions to include instant scratch cards offering discount offers and cash coupons for use in MTR network shops, with a grand lucky draw to win prizes worth up to HK\$50,000.

Miscellaneous business revenue including car park rental, souvenir ticket sales, new station connections and publications rose 1.9% to HK\$159 million.

Ngong Ping 360

Ngong Ping 360, the cable car running from Tung Chung to the Big Buddha and temple complex at Ngong Ping on Lantau Island, together with a theme village, opened in September and recorded revenue of HK\$64 million by year end. By March 2007, it has carried over 1 million visitors.

Octopus Holdings Limited

Octopus Holdings Limited (OHL) built on its success in providing payments services to transport and non-transport sectors. Our share of the profit in OHL rose by 70% to HK\$68 million.

Growth was driven by more service providers and higher usage. The number of service providers rose from 349 to 431, while Octopus cards in circulation and average daily transaction value rose from 13.2 million to 14.7 million, and from HK\$64.7 million to HK\$73.3 million respectively. Financial institutions providing Octopus automatic add-value service rose from 19 to 22.

By year end, 59 more green minibuses were accepting Octopus card, bringing the total to 2,806 – virtually the entire fleet. Red minibuses accepting the card increased from 171 to 215, and participating car parks rose from 203 to 231.

More retail chains also joined and the system was adopted in new sectors including churches, exhibitions, skating rinks, children's clothing stores and laundry services.

The Octopus Rewards Programme saw over 1.2 million cardholders having registered their cards, enabling them to enjoy benefits at ten participating partners.

External consultancy

Our consultancy business strategy focuses on key cities where such work may lead to investment opportunities in the Mainland of China or Europe, or consultancies which can enhance the skill sets of our staff. Consultancy revenue in 2006 was HK\$199 million.

The project management consultancy work on Shanghai Metro Line 9 proceeded well. The civil works from Songjiang New Town Station to Guilin Road Station were completed and the opening of Phase 1 by the end of 2007 remains on schedule. Projects for Shenzhen Metro, Tianjin Metro, Tianjin Binhai Mass Transit and the CSR Ziyang Locomotive Works were completed.

We signed a contract to provide consultancy for the Integrated Supervision Control System for Beijing Metro Line 5 and an agreement with Chengdu Metro Corporation for consultancy services. We also renewed our contract with Motorola Asia Pacific Ltd. to support the system design for a digital trunked radio system for the Guangzhou Metro.

In Hong Kong, the Automated People Mover System construction project, connecting the Hong Kong International Airport to SkyPlaza and the SkyPier made good progress.

In Taiwan, contracts began for the Kaohsiung Rapid Transit Corporation and Taiwan High Speed Rail Company. In Dubai, we were awarded a contract to provide engineering advice, while in the UK, we secured a number of consultancy assignments.

Rail Sourcing Solutions

Following a review we decided to exit the rail related component sourcing business and closed Rail Sourcing Solutions (International) Limited.

Property business

Our property development business benefited from a steady property market in 2006, whilst the investment portfolio was supported by rising rentals, high demand, a strong economy and vibrant tourism.

Property development

Profit from property developments was HK\$5,817 million, with the bulk of profit from surplus proceeds relating to The Grandiose, Central Heights and Metro Town (Tiu Keng Leng Phase I) developments in Tseung Kwan O and deferred income from Airport Railway projects.

Along the Airport Railway, profit was recognised from deferred income, in line with construction progress, at Harbour Green (Olympic Package Three), Coastal Skyline and Caribbean Coast (Tung Chung Packages Two and Three respectively), fit-out works at Elements in Kowloon Station and from receipt of the shell of an additional gross floor area of 7,609 square metres of retail space at Elements. Sales and pre-sales were good, including those for Harbour Green, Olympic Package Three, and for La Rossa in Coastal Skyline, Tung Chung Package Two.

Several major developments were completed. Elements, the upscale retail development at Kowloon Station, obtained the Occupation Permit for its first phase in December. Units of The Arch, also at Kowloon Station, were handed over to individual owners. Harbour Green at Olympic Station, La Rossa in Coastal Skyline and Crystal Cove (Towers 15 and 16) of Caribbean Coast in Tung Chung obtained their Occupation Permits.

At Caribbean Coast in Tung Chung, the Master Layout Plan for garden houses was approved and foundation works began. At Maritime Square, Tsing Yi, we received town planning approval to convert part of the adjacent lorry park and transport interchange to retail use.

Along the Tseung Kwan O Line, development profit came primarily from surplus proceeds from Metro Town (Tiu Keng Leng Phase I), The Grandiose (Area 55b), and Central Heights (Area 57a). Presales of Le Point, Phase 2 of Tiu Keng Leng, drew a very good response, as did sales for The Grandiose and Metro Town (Tiu Keng Leng Phase I) Towers One, Two, Three and Five.

Two major developments were completed, The Grandiose and Metro Town (Tiu Keng Leng Phase I). The Edge, a majority owned shopping centre located at the podium floors of The Grandiose was completed and opened for business, became our sixth shopping centre.

In January, we awarded the tender for Package Two of Tseung Kwan O Area 86, with a gross floor area of 309,696 square metres, to Rich Asia Investments Limited, a subsidiary of Cheung Kong (Holdings) Limited. The Development Agreement was executed in February. We advanced an interest-free loan of HK\$4 billion to Rich Asia Investments Limited in return for an increased sharing in kind of the development. The loan is backed by a parent company guarantee.

In November, the shopping centre at Tiu Keng Leng Station was sold to a subsidiary of Cheung Kong (Holdings) Ltd.

A revised master layout plan for Area 86 was accepted by the Town Planning Board in November.

In February 2007, we awarded the tender of Tseung Kwan O Area 56 to Lansmart Ltd, a subsidiary of Sun Hung Kai Properties Ltd. The proposed

development will be a mixed-use project comprising hotel, office, residential, commercial and car parking accommodation with a total gross floor area of not more than 168,537 square metres (including 5,407 square metres for a public transport interchange and associated facilities).

Investment properties

Revenue from investment properties increased by 6.8% to HK\$1,263 million as rental rates increased and we added the new majority owned shopping centre The Edge, with a lettable floor area of 7,683 square metres, to our portfolio. Growth was helped by shopping centre enhancements, stronger consumer demand, an improved employment market, the positive wealth effect from the stock market rally and tourism development on Lantau Island. On average, rental reversions for renewal of leases and reletting increased by 16%.

Demand for high quality retail space enabled the Company to maintain 100% occupancy levels at all its shopping centres, except Luk Yeung Galleria, where 427 square metres of lettable retail space were repossessed ahead of planned renovations. Our wholly owned wet market with lettable floor area of 508 square metres opened in Tung Chung. Phase I of Elements, our majority owned upscale mall at Kowloon Station, with gross floor area of 82,750 square metres, is expected to open by the end of 2007. As at March 2007, 90% of the retail space has been committed by tenants. The Choi Hung Park n' Ride Carpark, in which we have a 51% share, opened during the year.

In total at year end, the overall investment property portfolio attributable to the Company comprised 133,927 square metres lettable floor area of retail properties, 39,529 square metres lettable floor area of offices and 1,460 square metres lettable floor area of other usage.

A major renovation programme at Telford Plaza I was completed and the Heng Fa Chuen wet market reopened after renovations. Our 18 floors at Two IFC remained fully let.

Property management and other services

Property management business revenue rose 12.0% to HK\$149 million. During the year, 4,518 residential units were added to our portfolio, bringing the total number of residential units we manage to 58,876. A total of 16,546 square metres of commercial properties were also added, and including the wet market in Tung Chung and 24-hour passage walkway at The Edge, resulted in total commercial and office area of 582,073 square metres under management.

Business in the Mainland of China

Our property consultancy, management and related businesses continue to grow in the Mainland of China.

In Beijing, three new property management contracts for office/commercial developments were committed: SOHO Shangdu, Jian Wai SOHO Phase 7 and Chao Wai SOHO. We now have seven property management contracts in the Mainland of China, with a total area of 1,020,254 square metres. We also signed a long-term head lease for the operation of Oriental Kenzo shopping centre, which was extensively redecorated and close to 90% let as of year end. With a lettable floor area of 19,349 square metres, the shopping centre was renamed as Ginza Mall and opened in January 2007.

Hong Kong network expansion projects

During 2006, we were engaged in the planning and construction of several projects to enhance or extend the existing network.

Station and tunnel projects

Work is underway on the new Tseung Kwan O South Station at Area 86, and is due to be completed in early 2009, coinciding with the completion

of the first property package. Electrical & mechanical contracts were awarded, station substructure works were completed and construction of the superstructure began.

With the Government's plan in Hong Kong Central District proceeding, the Company is extending the Airport Express overrun tunnel beyond Hong Kong Station. The tunnel is expected to be completed in 2009.

Network extensions under consideration

The West Island Line will extend the Island Line from Sheung Wan Station to Kennedy Town via Sai Ying Pun and University stations. Draft gazette plans were submitted to the Government, and a revised project proposal submitted to the Environment, Transport and Works Bureau.

Under the South Island Line (East) proposal, a medium capacity railway service would run from Admiralty Station to South Horizons on Ap Lei Chau via Ocean Park, Wong Chuk Hang and Lei Tung. We continue our discussion with the Government with the aim of obtaining approval for this project.

The Company also continued to discuss proposals for the North Island Line alignment, an extension of the existing Tung Chung Line along the north shore of Hong Kong Island.

The new departure platform linking SkyPlaza at the Hong Kong International Airport with the Airport Express opened in February 2007, while the Queensway Subway linking Admiralty Station with Three Pacific Place also opened in February 2007.

The design of a pedestrian subway at Sai Yeung Choi Street South linking Pioneer Centre and Prince Edward Station is under review. The Government has, meanwhile, authorised a pedestrian subway at Cheung Lai Street connecting Lai Chi Kok Station with the new developments at the south of Lai Chi Kok Road. Work is expected to begin in the first quarter of 2007 and is scheduled for completion in early 2009.

In July, we submitted a proposal for construction of two underground entrances linking the concourse of Tsim Sha Tsui Station with the redevelopment of the former Hyatt Hotel. Work is scheduled to begin in 2007 for completion in 2010.

A pedestrian subway is also planned to link Tsim Sha Tsui Station's northern platform with the basements of adjoining developments. Work is expected to start in 2009 for completion in 2012.

In November, a proposal for an Underground Pedestrian Link scheme at Causeway Bay Station was submitted to the Government, and pedestrian links are also under consideration at five more stations.

Overseas growth

We made steady progress in our international growth strategy, with the final approval for the Beijing Metro Line 4 (BJL4) project, preparation work for other projects in the Mainland of China and further exploration of opportunities in Europe.

Mainland of China

BJL4 is a RMB15.3 billion project, of which 30% or approximately RMB4.6 billion is being borne by a Public-Private Partnership (PPP) company 49% owned by MTR Corporation. The investment by the PPP company will be financed 30% by equity and 70% by two RMB1.6 billion 25-year non-recourse bank loans provided by the Industrial and Commercial Bank of China and China Development Bank. The remaining 70% of the project cost is being funded by the Beijing Municipal Government. The PPP company has a 30-year Concession Agreement.

In January, following the approval of the National Development and Reform Commission (NDRC), the PPP company's business licence was granted and in April the Concession, Lease and Financing agreements signed. Contracts for the rolling stock, signalling and automatic fare collection systems were awarded and 23 of the line's 24 stations are under construction. Completion of construction is expected by 2009.

In Shenzhen, we are awaiting approval from the NDRC to build Phase 2 of Shenzhen Metro Line 4, and operate Phase 1 and Phase 2 for 30 years. We also made further progress on similar potential projects in key cities including Shenzhen, Beijing, Hangzhou, Wuhan and Suzhou.

Europe

Our strategy in Europe continues to be to pursue "asset-light" operating service contracts, with a primary focus on the UK and Scandinavian markets.

In October, the Company and Laing Rail submitted a joint bid for a gross cost service contract for the newly formed London Rail Concession. In December, Transport for London selected our partnership as one of two bidders to submit a Best and Final Offer and a decision is expected in mid 2007.

In November, we entered into a 50/50 joint venture with Swedish railway company SJ to prepare a joint bid for the Öresundståg concessions in Sweden and Denmark for submission in February 2007. The successful bidder will take over in 2008.

Our bid for the South Western Franchise in the UK was unsuccessful and the contract was awarded to the incumbent franchise holder.

Human resources

We have an excellent record of attracting and retaining high calibre people, and during 2006 we continued to provide comprehensive staff training programmes.

The proposed rail merger with KCR is a key issue for staff and we are committed to looking after their interests. Tremendous effort has been made to communicating the merger's possible implications through wide ranging internal communication channels, including a merger newsletter published jointly by both companies. We are also working to ensure a smooth integration by aligning work cultures and human resource policies and practices.

Our efforts to provide a safe and harmonious working environment saw us awarded the Caring Company Logo 2005/06 and again for 2006/2007 by the Hong Kong Council of Social Service. The award recognises initiatives such as the "More Time Reaching Community" programme that involved more than 1,500 Company volunteers in 81 initiatives helping the elderly, underprivileged children and others.

During 2006, we continued to provide wide-ranging training programmes to our staff. Two Company apprentices received

Outstanding Apprentices/Trainees Awards from the Vocational Training Council – the ninth consecutive year we have received such recognition. In addition, 17 trainers successfully acquired China's National Enterprise Trainer Qualification, which will help support our growth strategy in the Mainland of China.

Developing talent for general management is crucial and three key initiatives continued to ensure we attract and retain world-class talent. The People Development Initiative identifies and develops high potential staff at executive and senior managerial level. The Executive Associate Scheme identifies and fast tracks development of high potential staff at the middle management level. Finally, the Graduate Trainee Programme recruits and develops top graduates.

With our businesses outside Hong Kong growing rapidly, we established a designated HR team specifically to support the more than 170 staff working internationally. We also launched a "Stay-in-touch Employee Care & Communication Programme" to enhance communication with staff working outside Hong Kong.

Financial review

Review of 2006 financial results

Profit and loss

Fare revenue from MTR Lines increased by 3.3% to HK\$5,911 million as a result of a 1.0% growth in patronage to 867 million and a 2.2% increase in average fare to HK\$6.82.

Fare revenue from Airport Express increased by 9.1% to HK\$612 million due to a patronage increase of 12.8% to 9.6 million resulting from growth in air passengers and the full-year effect of the AWE Station, partly offset by a decline in average fare to HK\$63.85 on lower average fares for AWE Station passengers.

Non-fare revenue increased 5.1% to HK\$3,018 million, comprising HK\$1,606 million from station commercial and other businesses and HK\$1,412 million from property ownership and management. In 2005, a one-off income was received from settlement of an early termination of a telecommunication contract. Excluding this and other minor non-recurring incomes, non-fare revenue would have increased 7.7%.

Income from station commercial and other businesses rose 3.3%, attributable mainly to growth in advertising income and shop rental, which rose 4.7% and 13.7% respectively. Ngong Ping 360, which opened in September, also contributed HK\$64 million to revenue. Income growth in telecommunications was affected by non-recurring income received in 2005 and continuous cannibalisation and pricing pressure in the mobile phone market. Consultancy and other miscellaneous business revenues were steady.

With continued growth in the retail market and the addition of more retail space and property management contracts in the portfolio, income from property ownership and management increased 7.3% to HK\$1,412 million. Rental income increased 6.8% to HK\$1,263 million thanks to higher rental rates, increased turnover rent received, the full-year operation of The Lane and the opening of the Choi Hung Park and Ride and The Edge. Property management income increased 12.0%, mainly attributable to the expansion of the management portfolio, including The Arch, The Grandiose and Metro Town.

Staff costs and related expenses rose 2.4%. Operational rents and rates fell 29.3%, affected by a one-off income from settlement with the Government on ratable value assessment relating to the Tseung Kwan O Line. Excluding this item, operational rents and rates would have increased 9.8%. Expenses related to station commercial and other businesses increased 23.7%, while property ownership and management expenses increased 31.1%. Project studies and business development expenses rose HK\$125 million due to increased development activities in Hong Kong, the Mainland of China and Europe, and pre-operating expenditure for Ngong Ping 360. Overall operating costs increased 7.1% to HK\$4,340 million.

Operating profit from railway and related businesses before depreciation increased 2.0% from HK\$5,101 million to HK\$5,201 million. Operating margin was 54.5%, compared to 55.7% in 2005.

Property development profit was HK\$5,817 million compared to HK\$6,145 million. This mainly comprised surplus proceeds from The Grandiose, Central Heights and Metro Town; recognition of deferred income from Coastal Skyline, Caribbean Coast, Harbour Green and Elements; and sharing-in-kind in respect of an additional floor area of 7,609 square metres at Elements.

Operating profit before depreciation was HK\$11,018 million, a fall of 2.0% from HK\$11,246 million. Depreciation charge amounted to HK\$2,674 million, a similar level as in 2005 after accounting for the addition of Ngong Ping 360 and other new assets, as well as the full year depreciation charge in 2006 for DRL and the AWE Station.

Net interest expense was HK\$1,398 million, an increase of 2.7%, owing to the rise in interest rates and the expensing of interest costs relating to DRL and the AWE Station which are no longer capitalised. With higher market interest rates, our average interest cost increased from 5.1% to 5.5%, while interest cover reduced from 7.6 times to 6.7 times. In compliance with the Hong Kong Accounting Standard (HKAS) 40 on revaluation of investment properties, the increase in market value of our investment properties of HK\$2,178 million pre-tax (HK\$1,797 million post-tax) was recognised in the profit and loss account.

Our share of net profit of OHL was HK\$68 million, an increase of 70%. Our share of costs for bidding for the South Western Train franchise in the United Kingdom was HK\$23 million. Tax expense, comprising mainly deferred tax provision, was HK\$1,411 million. Net profit fell 8.3% to HK\$7,758 million, of which HK\$7,759 million was attributable to equity shareholders, a drop of 8.2%. Earnings per share correspondingly decreased from HK\$1.55 to HK\$1.41.

Excluding investment property revaluation and the related deferred tax, underlying profit was HK\$5,962 million or HK\$1.08 per share, respectively 2.9% and 4.4% lower.

The Board recommended a final dividend of HK\$0.28 per share, amounting to HK\$1,554 million, with a scrip dividend option offered to all shareholders except those with registered addresses in the US or any of its territories or possessions. The Financial Secretary Incorporated 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. It also agreed to extend this commitment to 2009.

Balance sheet

Our balance sheet remains strong, with the bulk of assets invested in the railway system. Total fixed assets increased to HK\$106,943 million, mainly attributable to surplus from investment property revaluation, receipt of retail space (The Edge) at the Grandiose and 7,609 square metres gross of Elements and the capitalisation of Ngong Ping 360.

Railway construction in progress decreased to HK\$232 million, mainly resulting from transfer-out of the Ngong Ping 360 project costs to fixed assets upon completion, being partly offset by the additional capital expenditures on the SkyPlaza Platform at the Airport and the Tseung Kwan O South Station projects.

Property development in progress increased to HK\$3,297 million, mainly due to the capitalisation of interest in respect of an interest-free loan provided to the property developer of Tseung Kwan O Area 86 Package Two development, partly offset by reimbursement, received from the developer of the same project, of up-front costs expended.

Properties held for sale increased to HK\$2,018 million from HK\$1,311 million, comprising mainly unsold residential units at The Grandiose, Central Heights, Metro Town and The Arch.

In line with the requirements of HKAS 39, derivative financial assets and liabilities of HK\$195 million and HK\$515 million respectively were recorded, as compared to HK\$234 million and HK\$307 million last year. The movements were mainly due to higher US interest rates and stronger Hong Kong dollar forward exchange rates during the period, causing a decline in the value of the Group's interest rate and currency fair value hedges.

Debtors, deposits and payments in advance decreased significantly to HK\$1,894 million because of collection of receivables from purchasers of pre-sold residential units.

An interest-free loan of HK\$4,000 million to the property developer of Tseung Kwan O Area 86 Package Two was recognised at its fair value of HK\$3,232 million at inception. As at year end, this loan receivable carried a balance of HK\$3,355 million after recognition of capitalised interest of HK\$123 million accrued during the year.

The carrying amount of total debt outstanding at year end was HK\$28,152 million. Excluding the mark-to-market and hedge accounting effects, total debt outstanding was HK\$28,768 million, an increase of HK\$94 million. Total debt drawn down was HK\$8,428 million, primarily for refinancing.

Deferred income decreased to HK\$1,682 million following profit recognition at Tung Chung, Kowloon and Olympic station development packages.

Deferred tax liabilities increased to HK\$9,453 million mainly attributable to the tax effect on profit, including provision on property revaluation, at the standard Hong Kong Profits Tax rate of 17.5%.

Share capital, share premium and capital reserve increased by HK\$1,189 million to HK\$38,639 million due to shares issued for scrip dividend and share options exercised. Together with increases in fixed asset revaluation and other reserves of HK\$253 million and retained earnings net of dividends of HK\$5,450 million, total equity attributable to equity shareholders increased to HK\$76,767 million. As a result, the debt-to-equity ratio improved from 40.4% to 36.7% and net debt-to-equity ratio from 39.9% to 36.3%.

Cash flow

The Company's cash flow position remained strong during the year with net cash inflow of HK\$5,400 million generated from recurring businesses and HK\$4,400 million of cash receipts from property developers and purchasers. After payments for capital expenditure, interest expenses, changes in working capital and dividend payments, the Company recorded positive cash flow of HK\$3,866 million for the year, before a one-off interest-free loan of HK\$4,000 million provided to a property developer. After this one-off loan advance, there was a cash deficit of HK\$134 million which was financed by increase in debt of HK\$94 million and drawdown of cash balances of HK\$40 million.

Financing activities

New financings

The Group continued to focus its fund raising activities in the Hong Kong dollar market to take advantage of its strong liquidity and low interest rates. In February and November, we successfully launched two separate fixed rate MTN issues via private placement, a HK\$500 million 2-year note and a HK\$1.0 billion 3-year note with respective coupon rates of 4.3% and 4.15%.

The excess liquidity in Hong Kong also helped further drive down credit spreads in the banking market, enabling the Group to enter into bilateral loan facilities on attractive terms. In total, the Group arranged HK\$2.6 billion of new bilateral bank loans comprising HK\$1.5 billion in 5 years maturity and HK\$1.1 billion in 7 years maturity. This, together with the MTNs issued, resulted in total new financings of HK\$4.1 billion.

At year-end, the Group had total undrawn committed facilities of HK\$5.7 billion, which together with cash on hand and projected positive operating cash flow during 2007, would provide sufficient coverage for anticipated funding needs in 2007.

Cost of borrowing

Our exposure to interest rate risk is well contained due to our conservative mix of fixed and floating rate debts, and ability to secure attractive fixed rate financings. Despite a significant increase in short-term

rates in the first half, average borrowing costs for the year rose to 5.5% from 5.1% from 2005, while gross interest expense increased by HK\$49 million to HK\$1,524 million.

Risk management

We continued to maintain a well-diversified debt portfolio in accordance with our Preferred Financing Model. The Model seeks to diversify risks by specifying the preferred mix of fixed and floating rate debts, maximum currency exposure, a well-balanced spread of maturities, use of different types of financing instruments and an adequate length of financing horizon to provide sufficient forward coverage of our future funding needs.

We remain an active corporate user of derivative financial instruments, which are used solely for hedging purposes to reduce exposure to interest rate and currency risks. To control counterparty risk exposure, we deal only with counterparties with credit ratings of A-/A3 or better, and assign to each counterparty limit based on its credit rating. In addition, we adopt a risk monitoring framework based on the widely accepted "value-at-risk" and "expected loss" concepts to quantify and monitor these exposures.

Credit ratings

We were the first Hong Kong corporate entity to obtain internationally recognised credit ratings, and have since maintained ratings on par with the Government.

During the year, Moody's upgraded our long-term foreign currency issuer rating from A1 to Aa3 with a stable outlook. Moody's also reaffirmed our short-term issuer rating at P-1 and long-term local currency issuer/foreign currency debt ratings at Aa3, with a stable outlook which later was changed to positive.

Standard & Poor's also raised our long-term local/foreign currency ratings from AA- to AA whilst reaffirming our short-term local/foreign currency ratings at A-1+ with a stable outlook.

This was followed by R&I's upgrade of our long-term foreign currency rating from AA- to AA and reaffirmation of our short/long-term local currency ratings at a•1+/AA with a stable outlook.

Financial planning

We continued to use our comprehensive long-term financial planning model to plan our railway operations and evaluate new projects and investments. The model subjects all investments to rigorous evaluations that take into account our weighted average cost of capital and required rate of return. To ensure the results are reliable and robust, we carefully review all key assumptions used in the model, and conduct sensitivity analyses on key variables. To manage our cost of capital effectively, we also regularly conduct detailed assessment of our funding requirements and capital structure.

Financing capacity

Total capital expenditure for the three years between 2007 and 2009 is estimated to be approximately HK\$5 billion for existing railways in Hong Kong, HK\$1.4 billion for property investment in Hong Kong and HK\$6.4 billion for overseas investments, resulting in a total of HK\$12.8 billion.

Of the HK\$6.4 billion requirement for overseas investment, a RMB3.6 billion project loan for the Shenzhen Metro Line 4 project has already been secured. As such, total expenditures for the next three years are considered modest, and the Group is expected to have sufficient financing capacity to fund other new Hong Kong and overseas investments.