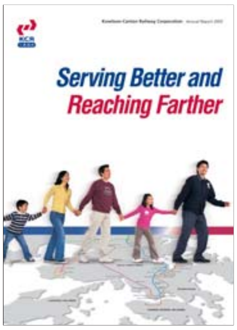
KCR
九廣鐵路

Kowloon-Canton Railway Corporation *Annual Report 2005*

Serving Better and Reaching Farther

KCRC: Serving Better and Reaching Farther



In 2005 the Kowloon-Canton Railway Corporation focused on building patronage for the two East Rail extensions commissioned in 2004, and developing feeder services and ticketing packages tailored to passenger needs.

The Corporation also continued its programme to further expand Hong Kong's railway network, completing important elements of the Lok Ma Chau Spur Line, and beginning construction of the Kowloon Southern Link.

The Corporation recognises that its success rests on its capacity to operate an efficient rail network and provide excellent service in support of that network, and in a drive to further enhance standards of service it launched the major "Go the Extra Mile" campaign, which developed finite service targets and worked to instil the Go the Extra Mile spirit of service excellence throughout the Corporation.

By serving better and reaching farther, the Corporation continues to contribute to Hong Kong's development and to satisfy the community's increasing demand for quality transport services.

Contents

Corporate Profile, Mission and Vision

Corporate Profile

Established in 1982, the Kowloon-Canton Railway Corporation (KCRC) is a public corporation providing high quality mass transport services in the Hong Kong Special Administrative Region. In addition to its core rail services, the Corporation designs and develops new railways and is active in property development and related commercial activities.

KCRC is one of the world's most successful railway operators: each day it carries about 1.5 million passengers. In recent years the Corporation has significantly expanded its network. West Rail, opened in 2003, extended rail services to the North West New Territories, and the completion of Ma On Shan Rail and the Tsim Sha Tsui Extension in 2004 further enhanced the network's reach and connectivity. The Corporation's 113-kilometre network now links much of the New Territories to Hong Kong's urban areas.

KCRC also contributes significantly to Hong Kong's social and economic development by enhancing cross-boundary rail services, developing new railways, and extending rail services to growing areas of the New Territories.

Mission and Vision

The Corporation's mission is to provide a safe, reliable, profitable and integrated railway network that meets the increasing demand for territorial, cross-boundary and intercity railway services.

KCRC is dedicated to finding better ways to:

- Serve customers and meet performance pledges
- Fulfil both Government and corporate objectives
- Maintain financial strength
- Develop sound business partnerships
- Build teamwork and commitment in staff
- Encourage initiative and reward success

The Corporation's vision is to be a world leader in providing quality transport services on the basis of prudent commercial principles.

Key Figures and Credit Ratings

> Financial Highlights

	2005 (HK$ million)	2004* (HK$ million)
Revenue from operations	**5,383**	4,976
Operating profit before depreciation, interest and finance income/expenses	**2,238**	2,060
Profit/(loss) after depreciation, interest and finance income/expenses	**(200)**	450
Net profit after tax	**317**	513
Capital expenditure	**3,835**	9,025
Interest-bearing borrowings (HK$ million)	**19,474**	19,748
Debt/equity ratio	**1:3.1**	1:3.0
Interest cover (times)	**1.9**	1.8

* *In 2005, a new set of accounting standards, the Hong Kong Financial Reporting Standards, came into effect in Hong Kong, replacing the Hong Kong Statements of Standard Accounting Practice. The major impact of these new standards is in respect of the depreciation policy for the Corporation's assets, and the accounting treatments of the revaluation of investment properties and the valuation of financial instruments. In compliance with the new standards, 2004 comparative figures have been re-stated where necessary.*

> Credit Ratings

	2005	2004
> **Standard & Poor's**		
Short-term local currency corporate credit rating	**A-1+**	A-1+
Short-term foreign currency corporate credit rating	**A-1+**	A-1
Long-term local currency corporate credit rating	**AA-**	AA-
Long-term foreign currency corporate credit rating	**AA-**	A+
> **Moody's**		
Short-term issuer rating	**P-1**	P-1
Long-term domestic currency issuer rating	**Aa3**	Aa3
Long-term foreign currency issuer rating	**A1**	A1
Senior unsecured domestic currency debt rating	**Aa3**	Aa3
Senior unsecured foreign currency debt rating	**Aa3**	A1

The Corporation's senior unsecured foreign currency debt rating assigned by Moody's has pierced the Hong Kong SAR sovereign foreign currency debt rating ceiling of A1. Otherwise, the credit ratings for the Corporation assigned by Standard & Poor's and Moody's are at the same level as those of the Hong Kong SAR Government.

> Operating Highlights

	2005	2004
> **Number of passengers** (million)		
East Rail (including Ma On Shan Rail)	**325**	292
Intercity Through Train	**3.1**	3.0
West Rail	**65**	48
Light Rail	**136**	132
Bus (excluding East Rail buses)	**27**	20
Freight volume (million)		
Southbound goods (tonnage)	**0.4**	0.5
Northbound goods (tonnage)	**0.2**	0.3
Livestock (head)	**0.1**	0.4
Employees at year end (number)	**5,879**	5,874

> Average Daily Ridership

(passenger trips)	**2005**	2004	% Increase
East Rail domestic service* (including Ma On Shan Rail)	**656,200**	566,300	15.9
East Rail cross-boundary service* (to Lo Wu)	**235,500**	232,500	1.3
Intercity Through Train service	**8,520**	8,070	5.6
West Rail service	**179,200**	131,500	36.3
Light Rail service	**373,000**	359,800	3.7
Bus service (excluding East Rail buses)	**74,600**	56,660	31.7
Total average daily passenger trips	**1,527,020**	1,354,830	12.7

* *Average daily Ma On Shan Rail usage in 2005 was 101,700, which included passengers travelling within Ma On Shan Rail and passengers travelling between Ma On Shan Rail and all other East Rail stations including Lo Wu.*

> Performance

	2005 (%)	2004 (%)
East Rail punctuality*	**99.82**	99.7
East Rail ticketing equipment availability	**99.91**	99.9
Ma On Shan Rail punctuality*	**99.92**	–
Ma On Shan Rail ticketing equipment availability	**99.90**	–
West Rail punctuality*	**99.76**	99.5
West Rail ticketing equipment availability	**99.94**	99.9
Light Rail punctuality*	**99.94**	99.6
Light Rail ticketing equipment availability	**99.95**	99.9

* *Trains arriving at their destinations within three minutes of the scheduled time.*

> Passenger Safety

(injuries per million passenger trips)	**2005**	2004
East Rail	**0.74**	0.74
Ma On Shan Rail	**0.46**	–
West Rail	**0.55**	0.79
Light Rail	**0.17**	0.14

> Cross-boundary (Lo Wu) Daily Average Passenger Trips

	Passenger trips	% Increase/ (Decrease)
1996	130,157	10.4
1997	152,228	16.9
1998	178,802	17.4
1999	206,481	15.5
2000	229,120	10.9
2001	236,800	3.4
2002	251,600	6.3
2003	224,500	(10.8)
2004	232,500	3.6
2005	**235,500**	**1.3**

2005 Highlights

January 1

In aid of tsunami victims

KCRC launched a fund-raising campaign to assist the victims soon after many South Asian countries were devastated by a tsunami in late December 2004. Donations by the Corporation, its employees and customers totalled HK$1.4 million.

Environmental campaign

To demonstrate its ongoing commitment to environmental sustainability, KCRC launched the "Forever Green" campaign and 14 Wastewi$e goals, setting detailed 'reduce, reuse and recycle' targets.

March 3

Newsline Express contract signed

KCRC and Hong Kong Cable News Express Limited signed an agreement relating to the onboard Passenger Information Display System. The Newsline Express service is the first in Hong Kong to provide Cable TV News and other information aboard trains. The service has been operational on the East Rail, Ma On Shan Rail and West Rail fleets since August.

KCR Art Corner unveiled

To support appreciation of the visual arts, the Corporation launched the KCR Art Corner in East Tsim Sha Tsui Station. The exhibition space displays works by local artists and art students on a rotating basis.

April 4

Lok Ma Chau Station topped out

Lok Ma Chau Station, the future terminus of the Lok Ma Chau Spur Line, was topped out on 19 April. The four-storey station will be East Rail's largest when it opens in 2007.

Making the ISO grade

The Transport Division achieved certification to the new ISO 14001:2004 version of the international environmental standard. In another ISO development, the Corporation successfully passed its triennial ISO 9001 assessment. 2005 marked the eighth year since KCRC gained corporate certification to ISO 9001 and the twelfth year since it achieved its first ISO certificate.

Launch of East Rail One-Month Pass

The first East Rail One-Month Pass scheme was launched on 1 April. The offer, originally scheduled to last for six months but later extended to the end of March 2006, enables passengers to purchase a pass good for unlimited rides on both East Rail (excluding Lo Wu and Racecourse stations) and Ma On Shan Rail.

2005 Highlights

May 5

Full steam ahead for Kowloon Southern Link

The Director of Environmental Protection issued the Environmental Permit for the Kowloon Southern Link project on 3 May, and the Chief Executive in Council authorised the project under the Railways Ordinance on 24 June.

June 6

KCRC Destination Care

The Corporation launched the "KCRC Destination Care" campaign on 18 June to support the Government's initiatives to help the financially disadvantaged. Destination Care's "Educational Tour" programme received a Merit Award in the Social Welfare Department's Corporate Volunteer Service Project Competition 2005.

E-Ticketing for Through Trains

On 28 June the Corporation unveiled the new e-Ticketing service for Intercity Through Trains, enabling passengers to purchase Guangzhou-Kowloon Through Train tickets on-line by credit card almost any time and anywhere.

Wu Kai Sha property development project awarded

KCRC awarded the tender for the joint venture property development at Wu Kai Sha to a subsidiary of Sino Land on 24 June. Phase I of the project is expected to be completed in 2008.

July 7

Launch of the "Go the Extra Mile" campaign

The Corporation launched the "Go the Extra Mile" service excellence campaign to promote care for its customers and translate this care into service targets.

Light Rail improvement works completed

The completion of the Tsing Lun Road Footbridge in early July marked the end of the four-year, HK$2.3 billion Light Rail improvement project. Major works in the project, designed to reduce road accidents and shorten Light Rail journey times, included grade separations of the Light Rail tracks at several busy road junctions.

West Rail Octopus One-Month Pass

The Corporation launched the West Rail Octopus One-Month Pass, valid for unlimited journeys on West Rail, Light Rail, KCR Bus and other designated feeder services. The Octopus form of the Pass, previously available only as a magnetic ticket, offers passengers greater convenience.

Delays due to lightning strikes prompt improvements to earthing arrangements

On 21 July, West Rail experienced the most serious of a series of service delays that occurred between June and August. Corporation engineers determined that West Rail's earthing arrangements had been overwhelmed by the exceptional number and frequency of lightning strikes unleashed during severe summer thunderstorms. Measures have since been taken to strengthen the earthing arrangements.

September 9

Phase II improvement works at Lo Wu Station

The Corporation announced details of Phase II of the Lo Wu Station improvement works, which include the expansion and renovation of platforms and further improvements to the arrival concourse. The HK$74 million works should be completed by December 2006.

Launch of KCR Railbus – Disneyland

The Corporation launched KCR Railbus – Disneyland service and KCR Taxi – Disneyland service on 12 September, the day Hong Kong Disneyland opened to the public. The new services target Mainland visitors who cross the boundary at Lo Wu, and enable passengers to travel by East Rail between Lo Wu and Sheung Shui, and then by bus or taxi between Sheung Shui and Hong Kong Disneyland.

October 10

KCRC gains Gold Wastewi$e Logo

In October the Corporation received a Gold Wastewi$e Logo from the Environmental Protection Department for achieving all 14 of its Wastewi$e targets. The Government scheme recognises companies that demonstrate a clear commitment to environmental protection and waste reduction.

Farewell to diesel locomotives

In late October the Corporation bid farewell to four of its oldest diesel locomotives. The four, which boasted nearly two hundred years of collective KCRC service, were replaced by new, more environmentally friendly locomotives.

November 11

Construction of Kowloon Southern Link commences

A groundbreaking ceremony on 7 November celebrated the commencement of construction works on the HK$8.3 billion Kowloon Southern Link. The 3.8-kilometre Link will connect West Rail and East Rail. When it comes into operation in 2009 it will enable the one million residents of the North West New Territories to travel to urban Kowloon without changing trains.

December 12

Ma On Shan Rail One-Month Pass

On 25 December the first Ma On Shan Rail One-Month Pass went on sale. The pass entitles holders to unlimited journeys on Ma On Shan Rail and unlimited transfers between Ma On Shan Rail and East Rail (excluding Lo Wu and Racecourse stations) starting from 1 January 2006.

East Rail underframe component incident

In late December cracks were found in the welded supports of a compressor attached to the underframe of an East Rail train. The subsequent examination of all East Rail trains detected cracks in the welded supports of other underframe components. Short-term mitigation measures to ensure the safe operation of trains were immediately put in place. The Corporation is studying the root cause of the problem and developing long-term improvement measures.

Managing Board

Michael Tien BBS, JP

BSc, MBA
Chairman
Chairman of Strategic Human Resource Committee

Appointed Chairman in 2001. Chairman of The G2000 Group since 1979. Chairman of the Standing Committee on Language Education and Research, Chairman of Working Group on Secondary School Places Allocation & Medium of Instruction. Chairman of the Employees Retraining Board, Member of Education Commission, Manpower Development Committee and Guangdong Chinese People's Political Consultative Conference.

Samuel M H Lai

BSc, MBA, CGA, FCILT
Chief Executive Officer (Acting)
Member of Capital Projects Committee
Member of Property Committee
Member of Finance Committee
Member of Public Consultation Group on Railway Operations

Appointed Chief Executive Officer (Acting) in 2004. Joined KCRC in 1983. Appointed Finance Director in 1991 and Senior Director-Finance and Management in 2000. Vice Chairman, UITP Asia-Pacific Division, International Association of Public Transport. Council Member, The Hong Kong Management Association. Chairman, Membership Committee, The Hong Kong Management Association.

Vincent Lo Wing-sang JP

BA (Hons)
Board Member
Chairman of Property Committee
Chairman of Public Consultation Group on Railway Operations

Appointed in 1999. Senior Partner of Messrs Gallant Y T Ho & Co, Director of Shanghai Commercial Bank Trustee Ltd. Chairman of the Hong Kong Red Cross Blood Transfusion Service Governing Committee and Director of the Red Cross Council. Member of the Social Welfare Advisory Committee, and Member of the Committee on Museums of the Leisure and Cultural Services Department. Chairman of the Hong Kong Sinfonietta.

Frederick Ma Si-hang JP

BA (Hons)
Board Member
Member of Capital Projects Committee
Member of Finance Committee
Member of Property Committee
Member of Strategic Human Resource Committee

Appointed in 2002. Secretary for Financial Services and the Treasury of the Hong Kong Special Administrative Region Government.

Dr Sarah Liao Sau-tung JP

BSc, MSc, MPhil, PhD, R.P.E., FHKIE, FRSC
Board Member
Member of Capital Projects Committee
Member of Strategic Human Resource Committee

Appointed in 2002. Secretary for the Environment, Transport and Works of the Hong Kong Special Administrative Region Government.

Wan Man-yee BBS, JP

FHKIS, FRICS, RPS (GP)
Board Member
Chairman of Capital Projects Committee
Member of Audit Committee
Member of Property Committee
Member of Public Consultation Group on Railway Operations

Appointed in 2002. Registered Professional Surveyor (General Practice). Director of M Y Wan and Associates Limited. Panel Member of Municipal Services Appeals Board, President of Youth Outreach, Council Member of Hong Kong Federation of Youth Groups. Manager of Chi Lin Buddhist Secondary School (SOS), and Panel Member of Appeal Board on Closure Orders (Immediate Health Hazard).

Patrick B Paul CBE

MA, FCA, FHKICPA
Board Member
Chairman of Audit Committee
Member of Strategic Human Resource Committee

Appointed in 2002. Non-executive Director of The Hongkong and Shanghai Hotels Ltd, Johnson Electric Holdings Ltd, Kingsway International Holdings Ltd and Pacific Basin Shipping Ltd.

The Hon. Abraham Shek Lai-him JP

BA, Dip Ed
Board Member
Member of Audit Committee
Member of Capital Projects Committee
Member of Strategic Human Resource Committee

Appointed in 2004. Member of the Legislative Council representing the Real Estate and Construction Functional Constituency. Independent Non-executive Director and Audit Committee Member of Midas International Holdings Ltd, Paliburg Holdings Ltd, Lifestyle International Holdings Ltd, Chuang's Consortium International Ltd, NWS Holdings Ltd and See Corporation Ltd. Independent Non-executive Director of Titan Petrochemicals Group Limited and Regal Portfolio Management Limited. Director of The Hong Kong Mortgage Corporation Ltd. Member of the Court of the University of Hong Kong and the Council of the Hong Kong University of Science and Technology.

Prof Richard Wong Yue-chim SBS, JP

AB, AM, PhD
Board Member
Chairman of Finance Committee
Member of Capital Projects Committee

Appointed in 2004. Deputy Vice-Chancellor and Chair of Economics at the University of Hong Kong, Director of the Hong Kong Centre for Economic Research, Director of the Hong Kong Institute of Economics and Business Strategy. Member of the Hong Kong Government's University Grants Committee, the Exchange Fund Advisory Committee, Land and Building Advisory Committee, and Economic and Employment Council. Non-executive Director of ICBC (Asia) Limited, CK Life Sciences International Holdings Limited, Orient Overseas (International) Ltd, Pacific Century Insurance (Holdings) Ltd and Great Eagle Holdings Ltd.

Ng Leung-sing SBS, JP

Board Member
Member of Property Committee
Member of Finance Committee

Appointed in 2004. Vice Chairman of Chiyu Banking Corporation, General Manager, Bank-wide Operation Department, Bank of China (HK) Ltd. Independent Non-executive Director of Smartone Telephone Holdings Ltd and the Fisheries Development Loan Fund Advisory Committee. Director of the Bank of China (Hong Kong) Charitable Foundation, Member of the Council and the Court of Lingnan University. Hong Kong Deputy to the 10th National People's Congress, PRC.

Management Committee

Samuel M H Lai

BSc, MBA, CGA, FCILT
Chief Executive Officer (Acting)

Appointed Chief Executive Officer (Acting) in 2004. Joined KCRC in 1983. Appointed Finance Director in 1991 and Senior Director-Finance and Management in 2000. Vice Chairman, UITP Asia-Pacific Division, International Association of Public Transport. Council member, The Hong Kong Management Association. Chairman, Membership Committee, The Hong Kong Management Association.

Y T Li

BSocSc, MPhil, FCHKPWS, CMILT, MIRSE (HON)
Senior Director-Transport

Joined KCRC in 1984. Appointed Senior Director-Transport in 2003. Council Member of the Chartered Institute of Logistics & Transport in Hong Kong. Member of the Steering Committee on Principals' Professional Development, the Statistics Advisory Board, Users' Committee of the Immigration Department and the Logistics Services Council of the Federation of Hong Kong Industries.

K K Lee

BSc, MSc, MBA, CEng, MIEE, FHKIE
Senior Director-Capital Projects

Joined KCR in 1981, prior to its corporatisation. Appointed Director-East Rail in 1997 and Director-East Rail Extensions in 1998. Appointed Senior Director-Capital Projects in 2004. Member of the Committee on Apprenticeship and Trade Testing of the Vocational Training Council and the Construction Workers Registration Authority.

Daniel C Lam BBS, JP

FRICS, FHKIS, FHKIArb, FCIArb, RPS, AP
Director-Property

Joined KCRC as Director-Property in 2000. Member of the Administrative Appeals Board. Council Member of the Hong Kong International Arbitration Centre. Chartered Surveyor, Chartered Arbitrator and Authorized Person.

Lawrence Li

MBA, FCCA, FCPA, MBIM, MIIM
Director-Finance

Joined KCRC in 1983. Has held various positions in the Finance Division. Appointed Director-Finance in 2004.

Mimi Cunningham

BA, MBA, MA
Director-Human Resource

Joined KCRC in 2004 after relocation from the UK. Previously worked for the Hong Kong Jockey Club and Cathay Pacific Airways as Head of Human Resources and Head of Training and Development respectively.

Grace Lam

BA, MA
General Manager-Corporate Affairs

Joined the Corporation in 2004. Previously worked for the Hong Kong and China Gas Company Ltd. Council Member of the Hong Kong Academy for Performing Arts, Member of Advisory Council on Food and Environmental Hygiene and the Road Safety Campaign Committee.

David Fleming

Company Secretary and General Counsel

A solicitor admitted to practice in Hong Kong, England and Wales, and Australia. Appointed Company Secretary in 1997. Principal Legal Advisor to the Corporation since 1993, having formerly served as a solicitor in private practice in Hong Kong and Australia and in the Legal Department of the Hong Kong Government.

Note: Mr Ian M Thoms, Director-West Rail, left the Corporation in July 2005

Front row from left:
Y T Li, K K Lee, Samuel M H Lai

Back row from left:
David Fleming, Mimi Cunningham, Daniel C Lam, Lawrence Li, Grace Lam

Chairman's Statement

The theme for this year's report is the Corporation's commitment to serving better, reaching farther. Unlike the two previous years, 2005 did not see the opening of any new lines. The focus for 2005 has been to build patronage on the Corporation's network by offering passengers better services and a number of attractive rail travel options.

Michael Tien
Chairman

I have to acknowledge upfront that the Corporation was fortunate to achieve a net profit of HK$317 million for 2005. The opening of the Tsim Sha Tsui Extension in October 2004, Ma On Shan Rail in December 2004 and the adoption of new Hong Kong accounting standards resulted in increased full-year operating costs and depreciation charges for the Corporation in 2005.

In particular, depreciation charges for tunnels and viaducts have had to be doubled in 2005 as a result of the new Hong Kong accounting standards that were introduced with effect from 1 January 2005. However, improved passenger and commercial revenue plus unrealised accounting profits from the revaluation of financial instruments and investment properties more than offset these additional expenses.

But, unlike depreciation and operating costs, revenue and the value of financial instruments and property depend heavily on market conditions. Had the market been less positive for the Corporation in 2005, the profit could easily have been a loss.

Patronage Growth

Nearly 50% of the Corporation's operating costs arise from staff costs and wage inflation is again beginning to be seen in the local labour market. Having held down operating costs and not increased fares for eight years, there is now little scope for accommodating inflationary cost increases without compromising safety and service standards. A key focus of 2005 has thus been to build patronage on all lines so as to generate additional revenue from both fares and commercial activities associated with the railway network.

As regards the market for domestic rail travel, East Rail saw growth of nearly 16% in patronage from a daily average of 566,300 to 656,200 passengers per day, mainly due to the first full year operation of Ma On Shan Rail and the Tsim Sha Tsui Extension. Ma On Shan Rail now has

an average daily usage in excess of 100,000, being 112,000 in both November and December 2005, and rising to 120,000 in January 2006. The Tsim Sha Tsui Extension currently has an average daily usage of around 85,000, and reached about 94,000 in December 2005.

After two years of operation, West Rail patronage on weekdays and Saturdays now exceeds 200,000 passengers per day, more than double that when West Rail first opened.

The cross-boundary market presented a less positive picture. In previous annual statements I have mentioned the Corporation's weakening position in the cross-boundary market. In 2005, rail's share of this market declined further from about 61% to about 59%. Growth of some 5.4% in the total cross-boundary market resulted in only a slight increase of 1.3% in the average daily patronage of rail despite the added convenience offered by the Shenzhen Metro, the opening of Disneyland and the major improvements that the Corporation has made at Lo Wu.

Competition from road-based modes of transport continued to grow, assisted by the completion in early 2005 of major improvement works at the Lok Ma Chau and Sha Tau Kok road crossing points. A further long-term trend is the westwards shift of development taking place in Shenzhen, with Lo Wu gradually becoming a less preferred location for cross-boundary passengers.

The opening of the Lok Ma Chau Spur Line in early 2007 may partially address this problem, although the opening of the Shenzhen Western Corridor, currently anticipated to take place at around the same time, can be expected to further impact adversely on the Corporation's competitive position.

Railway Incidents

One area where I am pleased to record improved performance on the new lines is in respect of incidents causing delays of eight minutes or more to passengers. On the KCRC network, there were 96 such delays in 2004, but only 93 in 2005 even with the addition of the full-year operation of the Tsim Sha Tsui Extension and Ma On Shan Rail.

For West Rail, which has been the particular focus of media attention, there were 26 delays of eight minutes or more in 2005, up slightly from the 24 recorded in 2004. However, the total duration of such delays in 2005 was about half that of 2004, resulting in passengers and services being substantially less affected.

The single most significant incident on West Rail in 2005 was the delays caused on 21 July by a failure of the signalling system arising from exceptional lightning storms. The Hong Kong Observatory recorded an estimated 10,000 lightning strikes that day in the North West New Territories. Consultants subsequently employed by the Corporation discovered that the faults were not caused by lightning striking the signalling system itself but because in isolated areas the earthing arrangements were unable to handle the induced electromagnetic effects resulting from the lightning striking the ground or structures nearby. Measures have since been taken to improve the earthing arrangements to prevent a similar occurrence.

On 21 December cracks were found in the welded supports of a compressor attached to the underframe of an East Rail mid-life refurbished train. Following detailed examination, further cracks were found in the welded supports of other East Rail mid-life refurbished trains. Similar cracking was not found in any new East Rail, Ma On Shan Rail or West Rail trains. Immediate remedial measures were put in place. These ensured the continued safe operation of the East Rail trains with minimal impact to services, before the root cause of the problem was determined and long-term solutions put in place. As at the time of drafting this statement, the final report identifying the root causes was not yet available.

Future Rail Projects

As regards future new lines, construction of the Lok Ma Chau Spur Line is well on target for opening in 2007. The ground-breaking ceremony for the Kowloon Southern Link project works took place on 7 November 2005. The Corporation submitted its final proposals for the Shatin to Central

Chairman's Statement

Link in September 2004 and the Government's decision is awaited. On 6 February 2006, the Government invited the Corporation to proceed with further planning of the proposed Northern Link and the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link as a combined project, and undertook to negotiate with the Corporation on the detailed cost of the combined project as well as the funding support arrangements.

Monthly Passes

There have been some noteworthy successes in 2005. Following the successful launch of a monthly pass for West Rail a year earlier, a similar pass allowing unlimited travel on East Rail and Ma On Shan Rail was introduced in April 2005 at a privilege price of HK$300 per month.

By the end of 2005, the East Rail One-Month Pass was revenue positive for the Corporation and was attracting nearly 50,000 purchasers each month, some 6,000 more than the average of 44,000 sold for West Rail despite the longer existence of the West Rail scheme.

Given the success of the two earlier passes, the Corporation introduced a Ma On Shan Rail One-Month Pass on 1 January 2006 at a privilege price of HK$200 for a trial period of six months. The pass allows unlimited journeys to be made from stations on Ma On Shan Rail to any other station on the East Rail/Ma On Shan system (except Lo Wu and Racecourse), provided that one end of the journey starts or ends at a Ma On Shan Rail station. Some 20,700 Ma On Shan Rail passes were sold for use in January 2006 and 21,200 for February. This resulted in a drop in sales of East Rail monthly passes for the same two months to about 40,300 and 38,300 respectively. While the trial period still has four months to go, initial indications suggest that it may be difficult for the Corporation to extend the scheme beyond the trial period as sales of the pass are not generating sufficient additional passengers to compensate for the overall loss in fare revenue.

Commercial Revenue

A further area of success was in generating commercial revenue from non-transport activities. Although commercial revenue is only about one-seventh of fare revenue, its contribution to the bottom line is important, especially as many of the activities concerned do not attract the heavy depreciation charges encountered with transport projects.

In part, the increase in revenue over 2004 can be attributed to the upturn in the local economy, particularly in the latter half of 2005. This enabled the Corporation not only to raise rentals in its shopping centres and station concourses upon renewal of tenancies but also to benefit from tenants' upturn in business where rents are based on profit sharing, an arrangement often adopted for West Rail station shops.

Advertising revenue also increased, both through the innovative efforts of staff and because of the earlier than anticipated introduction of the Passenger Information Display System (PIDS) on the Corporation's trains. Known as Newsline Express, PIDS is an on-train audio-visual display system that provides passengers with a mixture of public information messages, quasi real-time news and advertising. When the system was first introduced there were some complaints about the sound level, even though quiet cars are available on the trains. We quickly responded to customers' concerns and, although not publicly announced, the sound levels were significantly reduced. The vast majority of passengers now appear happy with the system.

Variable Pay

The variable pay scheme for the Executive Directors completed its first full year in 2005. A portion of total remuneration (20% in the case of substantive Directors and 15% for others) was converted to variable remuneration related to performance and placed in a corporate variable pay pool. The final pool of variable pay to be distributed to participants was determined by performance over the year against 15 measures decided by the Managing Board early in the year. For each measure a threshold, target and outstanding measure was determined having regard to performance in previous years. The average of the actual performance against these 15

measures then determined the final size of the pool. This ranged from zero for a below threshold average performance to 150% of the initial pool for an outstanding performance.

In 2005, no performances were below threshold and 12 exceeded target. For example, despite the full year impact of the two East Rail extensions, train service performance for 2005 was 99.82% as against a target of 99.57%, which was the actual performance in 2004, and against a target of 129 for delays of eight minutes or more only 93 were recorded, which was lower than the figures of 97 and 96 recorded in 2003 and 2004 respectively. Transport revenue from fares was slightly down on target but this was offset by above target performance in commercial revenue and in reducing operating costs. The overall average performance of all 15 measurements was above target, although actual payments from the pool to each participant were subject to further adjustment by the Managing Board having regard to that individual's performance over the year.

The Merger

At the Government's request, the Corporation and the MTR Corporation Limited (MTRCL) submitted a joint report on the feasibility of a merger to the Government in September 2004. Since that time the Government and the MTRCL have conducted negotiations on the transaction terms. The Government's decision on the merger is awaited.

Members of the Managing Board

Membership of the Managing Board remained unchanged in 2005. I would like to express my personal thanks to my fellow Board Members for their positive contributions to the decision-making process of the Board over the past 12 months.

"Being wholly owned by the Government, the Corporation has to respond to the aspirations of the community as regards the provision of rail services, while having to conduct its activities in a prudent commercial manner."

Management and Staff

I have been the Chairman of the Corporation for just over four years. During that time I have come to appreciate the unique situation faced by the Corporation and its staff. Being wholly owned by the Government, the Corporation has to respond to the aspirations of the community as regards the provision of rail services, while having to conduct its activities in a prudent commercial manner.

It also has to behave with integrity and transparency. Although efforts are always made to present a full and balanced picture to the media and to the community at large, there are occasions when transparency results in the Corporation being portrayed unfairly in a negative light. This inevitably adds to the pressures faced by management and staff.

Reconciling and dealing with these sometimes conflicting demands and pressures is not an easy task. The fact that only one complaint is recorded for every half a million passengers carried indicates that the Corporation, and more importantly its staff who deal with the public on a daily basis, are relatively successful at this task. I know I share the support of my fellow Board Members in thanking staff for their efforts on behalf of the Corporation in 2005.

Passengers

While the saying "the customer comes first" may be regarded as somewhat of a cliché, I think that there is considerable merit in a slightly longer version, which is "the customer who comes first is the customer who lasts". In serving better, reaching farther, I can assure passengers that the Corporation will continue to place high priority on meeting their changing needs.

Michael Tien
Chairman
27 February 2006

Statement of the Chief Executive Officer

Though operating profit before depreciation and patronage grew during the year, increasing capacity and competition in the public transport market, and the sharp rise in depreciation costs placed great pressure on overall profitability. These factors will continue to have a significant impact on the Corporation's bottom line in coming years.

Samuel M H Lai
Chief Executive Officer (Acting)

Transport Operations

With the commissioning of West Rail in 2003, and the Tsim Sha Tsui Extension and Ma On Shan Rail in 2004, the Corporation's domestic rail network now comprises East Rail, with its two extensions serving the 1.2 million people along the North East New Territories corridor, and West Rail, together with Light Rail and buses serving the 1.1 million residents in the Western New Territories. In 2005, ridership on the domestic network totalled 1.3 million a day, an increase of 15.1% over 2004. The Corporation's share of Hong Kong's entire public transport market also increased from 12.2% to 13.6%.

In the internal North West New Territories public transport market, the Light Rail system has for many years enabled the Corporation to be the major operator. Together with its bus services, the Corporation retains some 61.2% of this market, as opposed to East Rail's 36.2% share of the internal North East New Territories market.

In large part this is due to the protection offered to Light Rail after it opened in September 1988 by the establishment of the Transit Service Area. While most of this protection was removed in 1993, any residual protection enjoyed by the Corporation will cease in October 2006. A study to examine how best to respond to this situation has recently been completed and we are now consulting the Government on the possible options.

As regards the East Rail cross-boundary market, the Corporation faced growing competition. Ridership at 235,500 passengers per day represented only 1.3% growth over 2004 although the cross-boundary market as a whole grew by some 5.4%. As in 2004, the Corporation's share of the cross-boundary market declined by a further 2% in 2005, dropping from 61% at the end of 2004 to 59% at the end of 2005. This is an area of key concern because, in carrying 15% of the Corporation's

patronage, the cross-boundary service generates some 40% of the Corporation's total revenue.

Intercity Passenger Services continued to gain passengers in 2005. The daily patronage figure averaged 8,520, up 5.6% from 2004. However, the Guangzhou-Kowloon Through Train's market share fell by 1.4% during the year to 24%, in the face of keen competition in the price sensitive leisure travel market.

While positive growth in patronage and revenue was achieved for both cross-boundary and domestic services in 2005, the reality faced by the Corporation is that demand in both these markets is growing slower than supply of transport capacity. The continuing construction of new roads such as the Shenzhen Western Corridor and Route 8 between Sha Tin and Cheung Sha Wan, the completion of new rail projects such as the Lok Ma Chau Spur Line and the Kowloon Southern Link, and the community's understandable demand for a choice of travel modes are together resulting in a total public transport capacity that will not be taken up by passenger growth for some years. This puts the Corporation in the position of having to run hard simply to stand still in terms of market share, a prime example in 2005 being the far lower growth in cross-boundary patronage (1.3%) than total market growth (5.4%). In the absence of increasing fares, the only way that the Corporation can generate additional revenue to offset the increased depreciation charges from its new lines is to develop and introduce marketing strategies that have the potential to increase both fare and non-fare revenue.

In the case of fare revenue, in 2005 the Corporation continued to attract new passengers through active marketing and promotional efforts, including the introduction of one-month passes for East Rail and Ma On Shan Rail, and the KCRC Tourist Pass Combo, KCRC Domestic Travel Pass and West Rail Discovery Pass. Programmes to enhance connectivity and accessibility, such as additional interchange discounts with other transport operators, new KCR bus routes and increased signage also continued throughout the year.

Non-transport Commercial Operations

The Corporation's non-transport commercial operations improved as a result of added marketing efforts made by the Commercial Team and Hong Kong's improving economy in 2005. At the end of the year, the occupancy rate of our commercial premises was 92%. During the year the Corporation carried out large-scale renovation works at Ocean Walk (formerly known as Pierhead Plaza), a major shopping centre adjacent to the Tuen Mun Pier. The renovated centre was around 90% leased out when it re-opened in February 2006.

The Corporation's advertising and exhibition operations also benefited from the Corporation's efforts to capitalise on the improved economy. The launch of Newsline Express, Hong Kong's first on-train audio-visual system with the provision of quasi real-time broadcasts was one of the major factors in the growth of advertising revenue. A partnership between the Corporation and Hong Kong Cable News Express Limited, the new service attracted advertising and promotional clients from many sectors.

Financial Results

Total revenue increased by 8.2% to HK$5,383 million from HK$4,976 million in 2004. Operating costs before depreciation increased by 7.9%, from HK$2,916 million in 2004 to HK$3,145 million. As a result earnings before interest, tax and depreciation increased from HK$2,060 million in 2004 to HK$2,238 million in 2005, which was quite satisfactory given that the Corporation's new lines are still in their infancy stage as regards patronage.

However, when depreciation is added, earnings before interest and tax decreased by 80% to HK$98 million from HK$491 million in 2004. This was mainly because in addition to the full year impact of the opening of the Tsim Sha Tsui Extension and Ma On Shan Rail, under the new Hong Kong accounting standards for 2005, the Corporation has to depreciate its tunnels and viaducts over the unexpired tenure of its vested land, which is normally 50 years, instead of their estimated useful economic lives of 100 years adopted in previous years.

Statement of the Chief Executive Officer

Other accounting standard changes require the Corporation to recognise the unrealised accounting profit on the change in the fair value of its financial instruments and investment property in the Income Statement. Net interest and finance expenses also increased significantly in 2005 from HK$41 million to HK$298 million, mainly because of the full year impact of the opening of the Tsim Sha Tsui Extension and Ma On Shan Rail. The bottom-line effect is that the net profit for 2005 was HK$317 million, a decrease of some 38% from the net profit of HK$513 million recorded in 2004.

New Railway Projects

While still continuing to await the Government's decision on the Shatin to Central Link, the Corporation is at different stages as regards progressing three new railways that will significantly enhance its network.

The Lok Ma Chau Spur Line project has entered the final phase of railway systems installation, and after testing and commissioning is scheduled to open for revenue operations in early 2007. Construction of the Kowloon Southern Link is underway and is programmed for commissioning in 2009. And the Government has invited the Corporation to proceed with further planning of the Northern Link and Express Rail Link as a combined project.

When these new lines are completed, the Corporation's network will provide an efficient, environmentally friendly way of travelling from East to West, North to South, and in a circle through the Kowloon Peninsula and the New Territories.

Property Development

The Corporation returned to the property development market in 2005 following a two-year Government moratorium on property development. The joint venture tender was awarded for a major residential project above Wu Kai Sha Station, and expressions of interest were invited from local property developers to undertake the Tai Wai Maintenance Centre joint venture residential project, which will be tendered early in 2006. Unfortunately, public objections delayed a number of other projects. The Corporation will continue to invite expressions of interest in development projects along West Rail and Ma On Shan Rail over the next several years.

East Rail Underframe Component Incident

In late December, an East Rail train was removed from operations after a warning light indicated a failure in a train component. Subsequent examination determined that there were cracks in the welded supports of a compressor attached to the train's underframe. The Corporation immediately undertook a very careful and comprehensive examination of the underframe components of all East Rail trains. This found other non-visible hairline cracks, which could only be detected using magnetic particle testing, in the welding of mountings supporting a number of other components.

A crack-monitoring regime was quickly set up that enables repairs or replacement of mountings and other equipment to be carried out before any risk is posed to passengers or services. With the help of experts, the Corporation is now determining the root cause of the problem with a view to implementing permanent remedial measures.

I must emphasise that the Corporation's fundamental objective throughout the incident was in ensuring the safety of its passengers, and the adequacy and reliability of its services. The approach taken by the Corporation's engineers is in line with world standards. With their efforts, trains have been operating safely and reliably throughout.

Although many of the Corporation's staff were involved in dealing with this incident, I would in particular like to offer my personal thanks to the staff of Ho Tung Lau Maintenance Centre. Their professionalism and extraordinary efforts in working around the clock and under great stress to perform all necessary examinations and repairs to ensure the safety of trains must be given due recognition. It is also gratifying to see staff from all Divisions and grades openly showing support for those staff involved, as well as Management.

Merger Discussions

The Government first mooted the possibility of a merger between the two railway corporations in June 2002. In response to the Government's request in February

2004, the Corporation and the MTR Corporation Limited (MTRCL) submitted a joint report on the feasibility of a merger to the Government in September 2004. Since then the Government and the MTRCL have conducted negotiations on the transaction terms. The Corporation has not been involved in these negotiations.

Inevitably over the past three and a half years staff have raised questions about the possible impact on them of a merger. The Corporation has continued to address staff concerns as all parties await the Government's decision. Staff have been assured that, in the event of a merger and if there is a need to select staff to work in the merged organisation, the selection would be handled fairly and equitably. I have further given a personal commitment that I will keep staff informed of the latest developments and consult them on all matters affecting them.

Service Excellence

I firmly believe that a major key to the business success of the Corporation is in providing services that not only meet but also anticipate and where possible exceed the expectations of our passengers. Early in 2005 the Corporation's senior management outlined a programme of corporate renewal and alignment centred on service excellence. In July, the Corporation launched the "Go the Extra Mile" (GEM) campaign, a comprehensive and integrated series of programmes focused on service excellence.

Under the GEM Steering Committee, which I chair, five working teams have been established to focus on the major service areas: Reliability; Passenger Information and Feedback; Customer Care; Publicity; and Change Management. During 2005 each team has made progress in developing and disseminating new service standards, as well as policies that will encourage service excellence. This will have to be a continuous long-term campaign for the next several years given that standards cannot always be changed overnight and that passengers' requirements also change over time.

> **“A major key to the business success of the Corporation is in providing services that not only meet but also anticipate and where possible exceed the expectations of our passengers.”**

Senior Management Changes

In June Mr. Ian Thoms, Director-West Rail, who joined the Corporation in 1998, left after having successfully completed his task of overseeing the planning, design and construction of the West Rail project. His contribution to railway infrastructure development in Hong Kong gained international recognition in 2002 through his being awarded the International Medal of the Institution of Civil Engineers. I would like to thank him for his contributions to both the construction of West Rail and the Corporation since 1998.

Looking Ahead

The Corporation will again face fresh challenges in 2006. The Government's announcement on the possible merger can be expected. We must work hard to ensure public confidence in the safety and reliability of KCRC services. In the face of competitive pressures, we must endeavour to increase patronage on all railway lines. And we must develop new and innovative methods to increase both fare and non-fare revenue.

Given the increasing competition faced in the crucial cross-boundary market, we must aim for the earliest possible opening of the Lok Ma Chau Spur Line. High priority will also have to be given to discussions with the Government on the cost and funding support arrangements for the combined Northern Link and Express Rail Link project.

In serving better, reaching farther, I remain confident in the ability of the Corporation and its staff to overcome all challenges in 2006.

Samuel M H Lai
Chief Executive Officer (Acting)
27 February 2006

KCRC Rail Networks

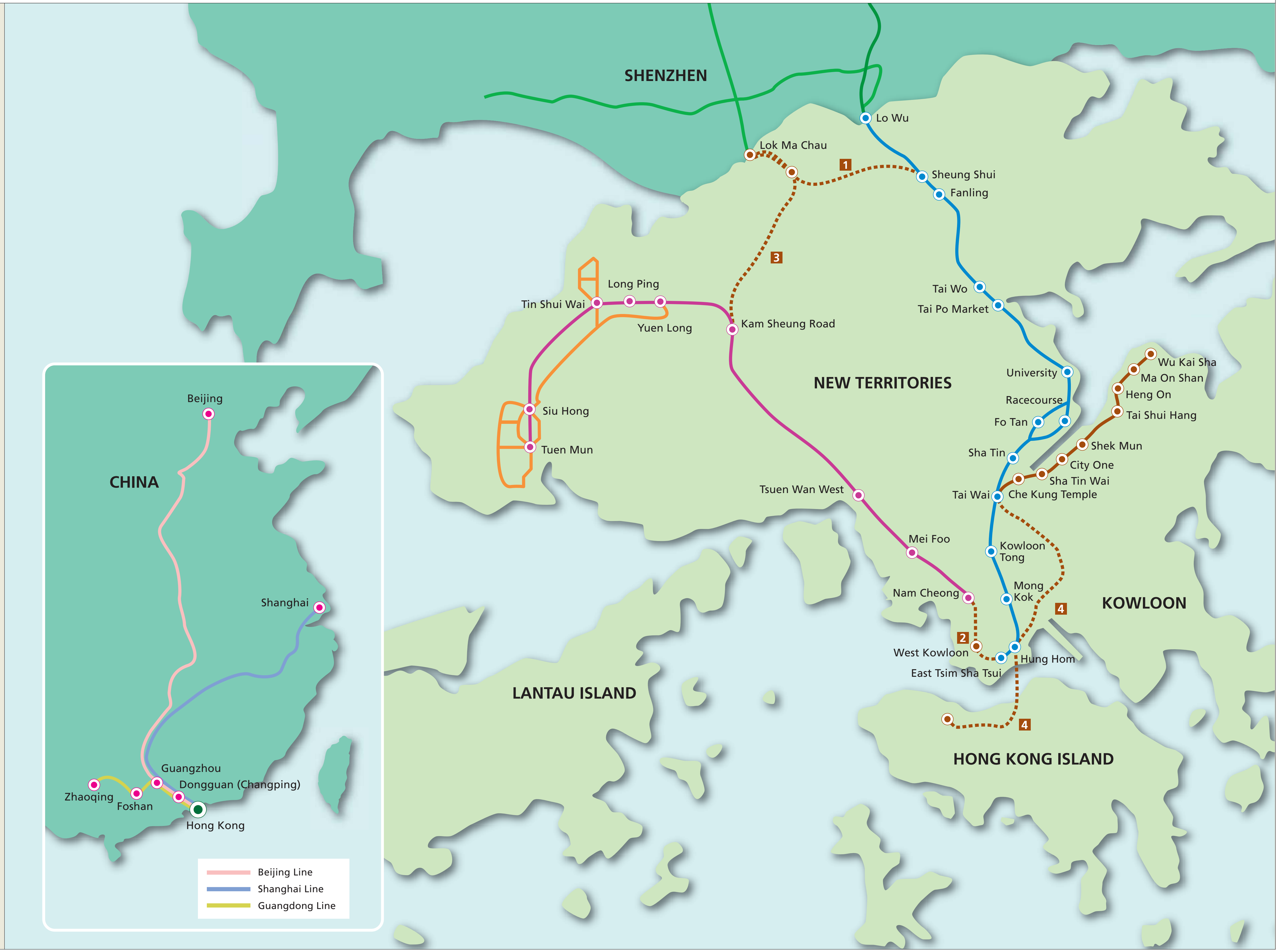
- East Rail
- Ma On Shan Rail
- West Rail
- Light Rail

1 Lok Ma Chau Spur Line (under construction)

2 Kowloon Southern Link (under construction)

3 Northern Link/Express Rail Link (under planning)

4 Shatin to Central Link (under planning)



Transport

The Corporation provides fast, convenient and environmentally friendly transportation for the people of Hong Kong.


"Caring service and a great network."

Transport > East Rail (including the Tsim Sha Tsui Extension and Ma On Shan Rail)

In 2005, the first full year of operations for Ma On Shan Rail and the Tsim Sha Tsui Extension, the Corporation worked to smoothly integrate the two new extensions into the East Rail network and build patronage. As a result of efforts to improve service and enhance ticketing flexibility, overall patronage rose consistently during the year.

Ma On Shan Rail's reliable service has attracted growing numbers of passengers.

Responsibilities

East Rail is Hong Kong's main north-south transportation artery, and Hong Kong's only rail link with the Mainland. With the addition of the two new extensions opened in late 2004, the Tsim Sha Tsui Extension and Ma On Shan Rail, the East Rail network has a total track length of 46.5 kilometres and 22 stations. The network's mass transit electrified rail service connects urban Kowloon with both the North East New Territories and the Mainland via Lo Wu.

In addition to regular East Rail services, the Corporation also operates an intercity passenger service to Guangzhou using its own train and provides access for other intercity trains running to and from major Mainland cities including Beijing, Shanghai and Guangzhou.

The Corporation also provides daily container, general cargo and livestock rail freight services between Hong Kong and the Mainland.

Domestic and Cross-boundary Passenger Service

Domestic patronage (including Ma On Shan Rail) averaged 656,200 passengers a day, 15.9% higher in 2005 than in 2004. Cross-boundary patronage increased to an average of 235,500 passengers a day during 2005, up 1.3% from 2004. However, cross-boundary services continued to face severe competition from road transportation and lost additional market share in 2005. East Rail's domestic market share was 36.2% for intra-New Territories travel and 46.6% for travel between the New Territories and urban areas. Its cross-boundary market share was 59%, down from 61% in 2004.

In their first full year of operations the Tsim Sha Tsui Extension and Ma On Shan Rail were integrated into the East Rail network without affecting passenger service. The extensions operated efficiently and reliably, as the Corporation continued to enhance various systems and response procedures in the drive to prevent incidents and reduce response time.

Ma On Shan Rail's average daily usage was 101,700, slightly below target, though patronage increased steadily throughout the year. The new extension achieved outstanding levels of service delivery and punctuality in its first year of operations, attaining 100% service performance on 341 days and 100% punctuality on 323 days. For the year as a whole, service delivery averaged 99.94% and punctuality averaged 99.92%.

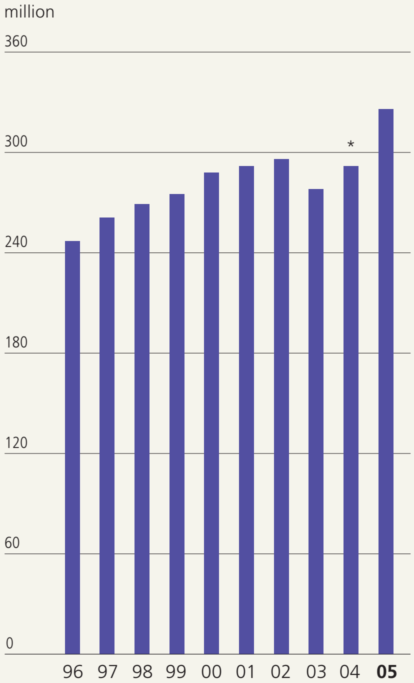
Several new ticketing initiatives were launched during the year to promote customer loyalty and attract new passengers. These included concessionary one-month passes for East Rail and, on a trial basis, Ma On Shan Rail, launched in April 2005 and January 2006 respectively, and the KCRC Tourist Pass Combo and KCRC Domestic Travel Pass, both launched in May. The Corporation

> East Rail (including the Tsim Sha Tsui Extension and Ma On Shan Rail)

> Route length (km)	
East Rail Main Line	35.1
Ma On Shan Rail	11.4
> Number of stations	
East Rail Main Line	14
Ma On Shan Rail (excluding Tai Wai Station)	8
> Number of rail cars	
East Rail Main Line	444
Ma On Shan Rail	72
> Daily hours of operation	19.5
> Daily number of trains	
East Rail Main Line	544
Ma On Shan Rail	494
> Minimum headway (minutes)	
Peak hours	
East Rail Main Line	2.5
Ma On Shan Rail	3
Off peak hours	
East Rail Main Line	5
Ma On Shan Rail	5
> Average daily ridership	
Domestic	656,200
Lo Wu	235,500
> Highest daily ridership in 2005	
24 December	1,184,900
> Intercity Passenger Services	
Destinations (number of Mainland cities)	6
Average daily passengers	8,520
> Freight in 2005	
Containers (TEUs)	13,035
Breakbulk (wagons)	4,140
Livestock (wagons)	888

Transport > East Rail (including the Tsim Sha Tsui Extension and Ma On Shan Rail)

East Rail Total Passengers



* The Tsim Sha Tsui Extension and Ma On Shan Rail commenced operations in October and December 2004 respectively.

> Service Targets and Achievements

	2005 Yardstick	2005 Performance
> **East Rail** (excluding Ma On Shan Rail)		
Service delivery	99%	99.84%
Punctuality	99%	99.82%
Availability of ticket vending machines	99%	99.56%
Availability of Octopus equipment	99%	99.93%
> **Ma On Shan Rail**		
Service delivery	99%	99.94%
Punctuality	99%	99.92%
Availability of ticket vending machines	99%	99.83%
Availability of Octopus equipment	99%	99.92%

withdrew the Second Trip Discount without incurring any significant loss in ridership.

Programmes to improve connectivity during the year included the completion of a 12,700-square metre Public Transport Interchange connected to Tai Wai Station. New feeder services and inter-modal discounts with other transport operators were launched during 2005, and by the end of the year inter-modal discounts were available on a total of 17 Green Mini Bus routes along East Rail and Ma On Shan Rail, further improving connectivity.

The Corporation launched a KCR Railbus - Disneyland service in September to coincide with the opening of Hong Kong Disneyland. Railbus passengers travel from Lo Wu to Sheung Shui on East Rail, and from Sheung Shui to Disneyland by luxury bus.

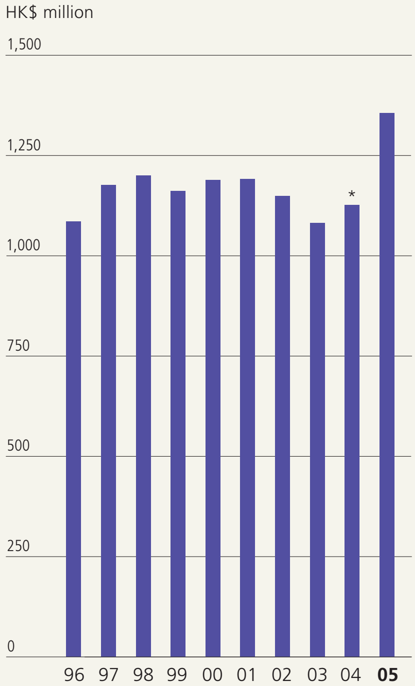
Service Improvements

In the face of growing competition in the vital cross-boundary market, the Corporation continued to improve its cross-boundary services and facilities, especially at Lo Wu. The introduction of immigration e-channels during the year helped relieve congestion at the busy station, where the Corporation has been working to improve passenger flow and enlarge and modernise public areas since 2002.

Phase I of the Lo Wu Station improvement works was largely completed during the year, and the Corporation announced Phase II of the works in September. The HK$74 million project will include the further expansion and renovation of platforms, and the installation of new escalators and travellators. The works, which will increase passenger throughput by 3,000 trips each direction per hour, should be completed by the end of 2006.

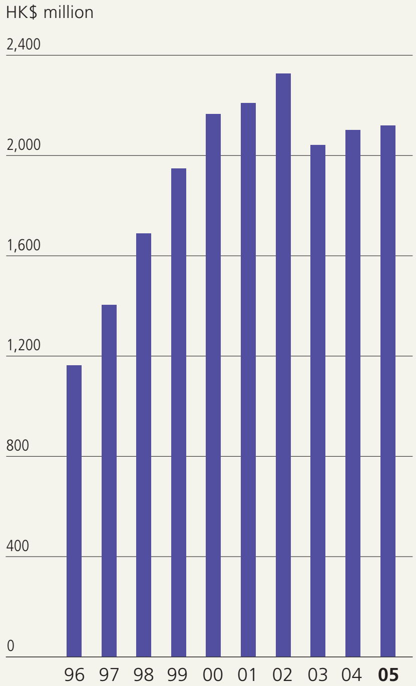
The East Rail Control Centre manages all traffic on East Rail and Ma On Shan Rail.

East Rail Domestic Revenue

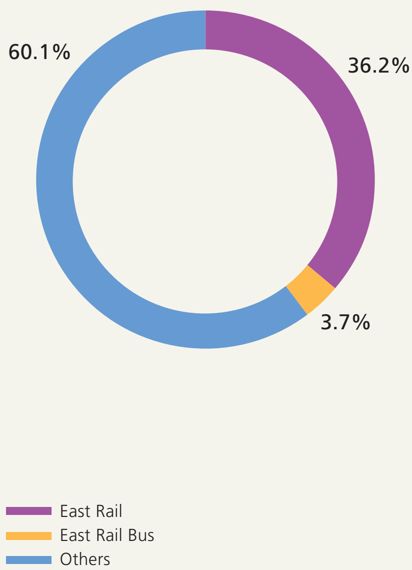


* The Tsim Sha Tsui Extension and Ma On Shan Rail commenced operations in October and December 2004 respectively.

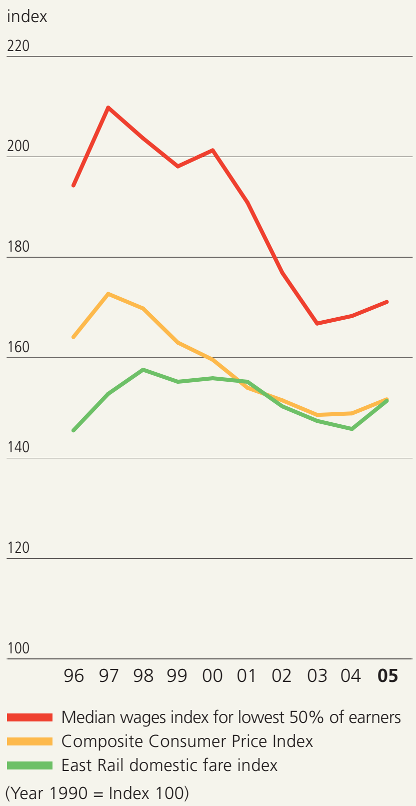
East Rail Cross Boundary Revenue



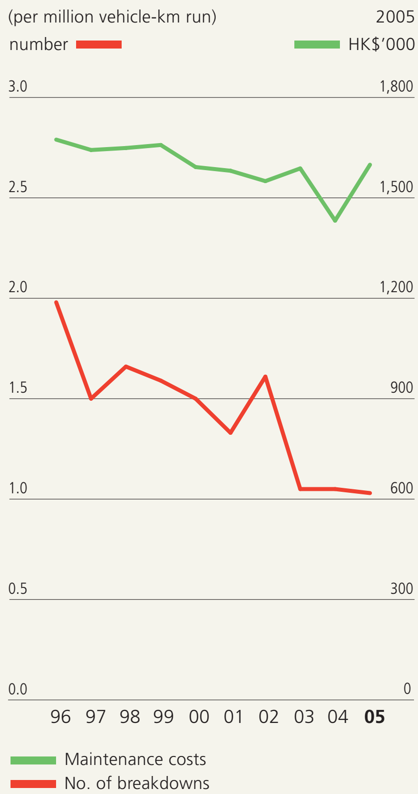
KCR's Market Share in the North East New Territories



Fares Relative to Income and Inflation



EMU (East Rail/Ma On Shan Rail/West Rail) Breakdowns vs Maintenance Costs



Substantial works were also completed at Sheung Shui Station in 2005. Track diversion works related to the Lok Ma Chau Spur Line, which will branch off the East Rail alignment at Sheung Shui, were completed without disrupting passenger service. In other improvements, the station concourse was extended and additional noise barriers were installed.

The Corporation installed air conditioners in all public washrooms at stations and will study the installation of Automatic Platform Gates and Mechanical Gap Fillers at all East Rail and Ma On Shan Rail stations.

Improvements to the Corporation's rolling stock included the installation of the Passenger Information Display System on refurbished trains and the launch of Newsline Express on all trains. The system provides passengers with quasi real-time news and other useful information.

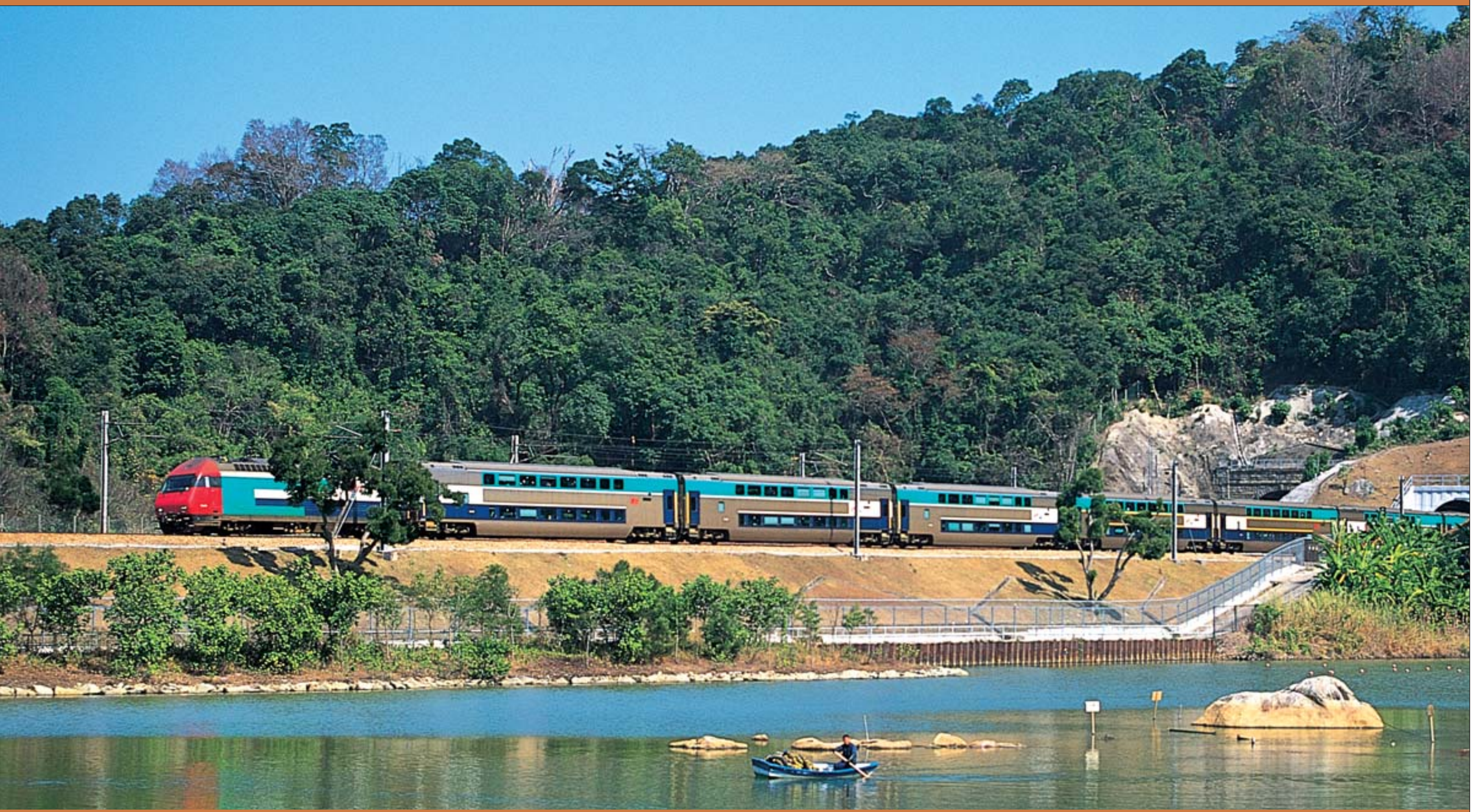
To offer passengers more choice, the Corporation established quiet zones on all trains and adjusted the system's volume. The new service has been welcomed by the majority of passengers.

Intercity Passenger Services

Intercity Passenger Services continued to grow in 2005, with the average daily patronage of through trains increasing to 8,520, up 5.6% from 2004. However, the Guangzhou-Kowloon Through Train's market share declined 1.4% during the year to 24%, due to keen competition in the price sensitive leisure travel market.

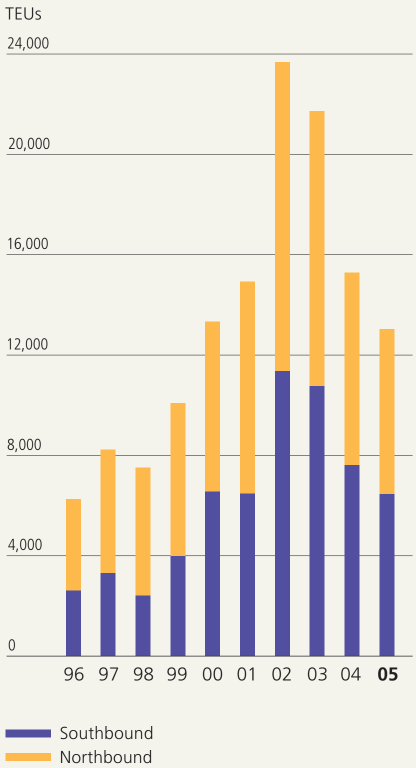
To offer passengers increased ticketing flexibility, in June the Corporation launched the Intercity Through Train e-Ticketing System, its first e-Ticketing service. By the end of the year more than 5,500 people had registered as e-Ticketing users.

In order to fully tap the growing market of Mainland Frequent Individual Travellers, the Corporation continued to offer through train passengers special packages through joint promotions with travel agents, hotels, entertainment, and retail outlets and tourist destinations. Trade partners during the year included China Travel Service, Rosedale on the Park Hong Kong, the Hong Kong Jockey Club and Duty Free Shoppers Hong Kong Limited.



The Corporation's new e-Ticketing services make booking tickets on Intercity Through Trains even more convenient.

Container Traffic



Relations with Mainland Railways

The Corporation has developed a close working relationship with the Mainland railways and boundary control authorities. These regular contacts and relationships continued in 2005.

In August, the Corporation participated in a Passenger and Freight Working Group meeting with the Ministry of Railways (MOR), Guangzhou Railway (Group) Corporation, Beijing Railway Administration, Shanghai Railway Administration and China Railway Container Transport Centre. The meeting, chaired by the Deputy Director-General of the Hong Kong, Macau and Taiwan Affairs Office of the MOR, dealt with commercial and operational issues in respect of through train and freight services.

Other representative interfaces with Mainland parties during 2005 included:

- A meeting in March with the Director-General of the MOR's Development & Planning Department to exchange views on the Express Rail Link alignment, the Mainland's express railway network plan and the railway development plan for the Pearl River Delta.
- Three high-level forums with boundary control units regarding improvements in cross-boundary passenger and freight clearance procedures.
- KCRC/Guangzhou Railway (Group) Corporation/Guangshen Railway Company Limited Passenger and Freight Working Group Meetings to resolve passenger and freight bussiness issues and formulate strategies to promote Guangzhou-Kowloon Through Train services and freight business.
- Sales meetings with the Beijing and Shanghai Railway Administrations to formulate marketing strategies for the Beijing/Shanghai-Kowloon Through Train services.
- A field visit to Guilin and meeting with the Guilin Tourism Bureau and Liuzhou Railway Administration to further study the feasibility of expanding through train service to Guilin.

The Corporation has also developed a cooperative relationship with the Shenzhen Metro, and the two parties have agreed to establish a joint information counter at the Shenzhen Metro's Luohu Station to provide ticketing and travel information. Both parties recognise that convenient interchange connections between East Rail and the Shenzhen Metro at Lo Wu and, from 2007, Lok Ma Chau will greatly facilitate cross-boundary passenger flows.

Freight

As the cost and efficiency of the Mainland's freight transportation services and infrastructure continue to improve, the Corporation's freight business continues to decline. In April 2005, the Managing Board therefore decided to phase out the Corporation's freight forwarding business in 2005, and to reposition the freight business as a carrier and terminal operator.

In view of the severe competition ahead, the Corporation continued to work with the Ministry of Railways, local railway administrations, customs authorities, and railway container companies to streamline cross-boundary formalities, develop block train services, improve transit times, secure competitive rail freight packages and provide value-added customer service. The approval processes for the commissioning of the Dongguan Freight Through Train and Suzhou Container Block Train also continued.

Looking Ahead

In 2006 the major goals for East Rail include the continued improvement of passenger and freight services and performance and increasing patronage. The Corporation will continue to explore additional means of enhancing service reliability and the speed of recovery if incidents do occur. Additional feeder routes, inter-modal discounts, and new marketing initiatives will be developed to boost patronage.

Improvement works at Lo Wu will finish in 2006, completing the improvement programme that began in 2002, thereby making travel more efficient and pleasant for passengers. In addition, the Corporation plans to further expand cooperation with travel agents, hotels and tourist destinations to offer more packages to through train passengers, and is exploring adding new routes to other Mainland cities, including Guilin.

The Corporation continues to streamline passenger flow at Lo Wu.

Transport > West Rail, Light Rail and Bus

West Rail ridership grew steadily and significantly in 2005, and the Corporation continued to integrate the West Rail, Light Rail and KCR Bus networks to meet the needs of customers in the North West New Territories. Reliability improved during the year and the Corporation strengthened earthing arrangements along West Rail after determining that a series of service delays were caused by exceptionally severe lightning strikes that overwhelmed existing earthing arrangements.

West Rail is steadily attracting and retaining passengers who live or work in the North West New Territories.

> Service Targets and Achievements

	2005 Yardstick	2005 Performance
> **West Rail**		
Service delivery	99%	99.82%
Punctuality	99%	99.76%
Availability of ticket vending machines	99%	99.88%
Availability of Octopus equipment	99%	99.95%

West Rail

Launched in 2003, West Rail is the direct rail link between the North West New Territories and urban Kowloon. The 30.5-kilometre railway runs from Nam Cheong to Tuen Mun, and includes nine stations. West Rail, supported by Light Rail and KCR Bus, provides an integrated transport network that serves the residents of the growing communities of the North West New Territories.

Passenger Services

West Rail continued to steadily attract and retain passengers in 2005, and average daily ridership increased to 179,200 in 2005 from 131,500 in the previous year, an increase of 36.3%.

West Rail's share of the New Territories-urban travel market increased to 16.9% during the year, up from 11% the year before. Its market share for intra-New Territories travel also increased, rising to 12.2%, from 8.9% in 2004.

The Corporation worked to increase West Rail patronage in a number of ways, increasing connectivity by adding new feeder services and interchange discounts, including four new free Green Mini Bus feeder routes, bringing the total number of Green Mini Bus routes with inter-modal discounts to 14.

The extension of the current West Rail One-Month Pass and its conversion to the Octopus format, as well as new special fares such as the Discovery Pass, also attracted new passengers. The single-day Discovery Pass, (known as the Festival Pass prior to 1 September) is valid for unlimited journeys on West Rail, Light Rail, KCR Bus and designated feeder services. A total of 1.2 million Discovery Passes were sold during the year.

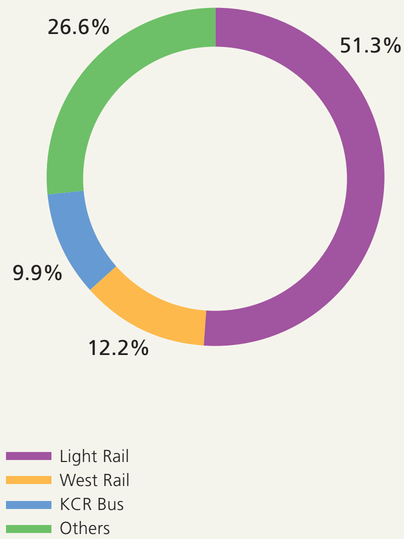
Service Improvements

Between June and August West Rail experienced a series of service delays that coincided with a series of extremely heavy thunderstorms. Corporation engineers determined that the system failures had occurred because West Rail's earthing arrangements had been overwhelmed by the extraordinary number and frequency of lightning strikes during the storms. The Corporation commissioned a

> West Rail

> Route length (km) Tuen Mun to Nam Cheong	30.5
> Number of stations	9
> Number of rail cars	154
> Daily hours of operation	19
> Daily number of trains	398
> Minimum headway (minutes)	
Peak hours	3.5
Off peak hours	6
> Average daily ridership	179,200
> Highest daily ridership in 2005 24 December	252,800

KCR's Market Share in the North West New Territories



consultant to study measures to improve the arrangements and began strengthening the earthing arrangements in August 2005. The programme will be completed by the middle of 2006.

Accessibility and connectivity continued to be improved at West Rail stations. Over 350 station signs directing passengers to feeder services were added or strengthened in 2005. Works on the installation of an additional lift and covered walkway at Mei Foo Station to facilitate access by nearby residents started in June 2005 and are expected to finish in 2006.

Light Rail

The Light Rail network is an important element of the Corporation's integrated transport system in the North West New Territories. Since the opening of West Rail, Light Rail services have been restructured to better meet the transport needs of the local residents by providing efficient feeder services to West Rail.

Passenger Services

Light Rail patronage continued to grow in 2005. There were an average of 373,000 passenger trips on Light Rail each day in 2005, compared to 359,800 in the previous year, an increase of 3.7%.

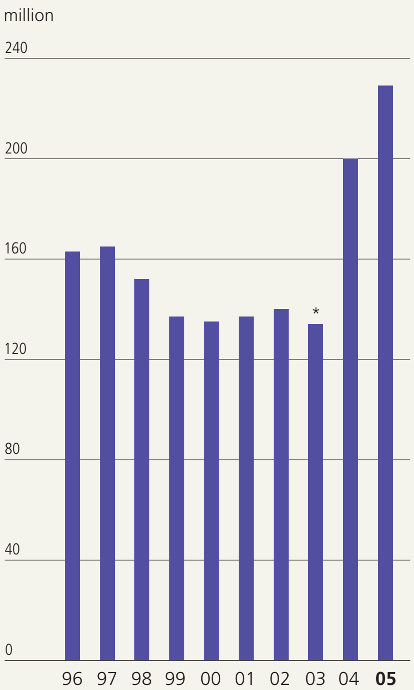
Light Rail's share of the internal public transport market in the North West New Territories remained stable during the year at 51.3%, compared to 51.4% in 2004.

Service Improvements

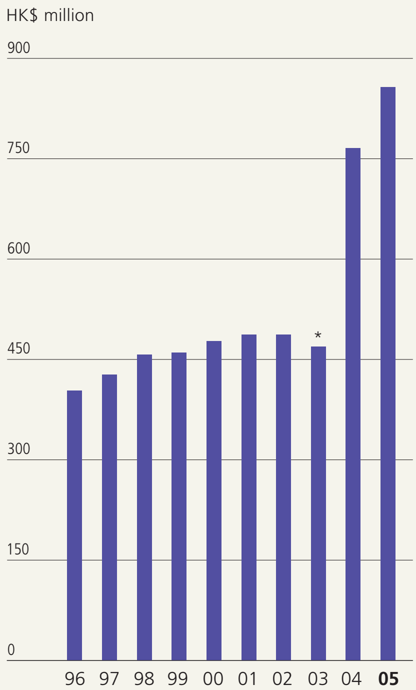
The July completion of the Tsing Lun Road Footbridge marked the end of a four-year, HK$2.3 billion Light Rail improvement works programme, which also included a series of major track elevation works. The improvement works enhanced pedestrian and road safety and increased Light Rail's operational efficiency.

In an upgrade completed without disruption to regular service, Light Rail's new signalling system was

West Rail and Light Rail Total Passengers



West Rail and Light Rail Revenue



* West Rail commenced operations in December 2003

> Service Targets and Achievements

	2005 Yardstick	2005 Performance
> Light Rail		
Service delivery	99%	99.96%
Punctuality	99%	99.94%
Availability of ticket vending machines	99%	99.89%
Availability of Octopus equipment	99%	99.96%

installed during the year. The project involved close coordination between many parties and the replacement of trackside signalling equipment, Operations Control Centre equipment and voice radio equipment.

Other service enhancements included the reconfiguration of Light Rail Vehicles to modify the seats, allowing them to carry more passengers, and the trial commissioning of the Passenger Information Display Unit in October.

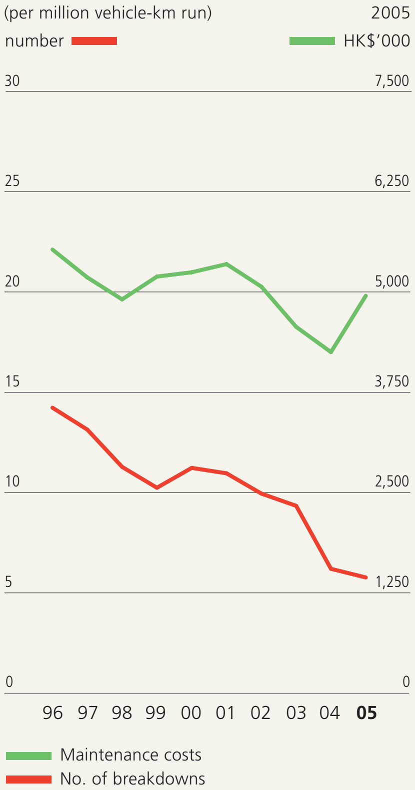
> Light Rail

> Total route length (km)	36.2
> Number of Light Rail vehicles	119
> Number of stops	68
> Daily hours of operation	19
> Daily number of trains	2,868
> Minimum headway (minutes)	
Peak hours	1.6
Off peak hours	2.0
> Total km run	11,087,087
> Average daily ridership	373,000
> Highest daily ridership in 2005	
16 September	432,860

Light Rail's convenient interchanges with West Rail are helping increase ridership on both networks.

Transport > West Rail, Light Rail and Bus

Light Rail Vehicle Breakdowns vs Maintenance Costs



> Bus

> Total number of buses	143
> Total number of bus routes (the operating right of six East Rail feeder routes was transferred to KMB in May, 1999)	15
> Total km run (West Rail feeder buses and residential/express routes only)	6,294,159
> Daily hours of operation	19
> Minimum headway (minutes)	5
> Average daily ridership (West Rail feeder buses in Transit Service Area only)	74,600

Continuing to increase accessibility for passengers with special needs, the Corporation added 19 voice and 76 short-poled Platform Contactless Smart Card Processors at various Light Rail stops to assist visually impaired and wheelchair passengers, respectively.

The Corporation successfully managed the network's peak demand period – the September back-to-school rush – by revising the weekday timetable and building in turn-short services. These measures ensured that trains were not overloaded and that there were minimal service disruptions.

Bus

The Corporation operates feeder bus services in support of West Rail, East Rail and Light Rail services. In 2005 the Corporation continued to adjust bus routes and schedules in response to shifting passenger demand. After decreasing significantly in 2004, average daily bus ridership increased 31.7% to 74,600 in 2005.
Bus operating costs increased substantially during the year as fuel costs rose.

At the end of 2005, there were a total of 15 KCR Bus routes, including feeder services and residential routes, but excluding East Rail feeder services. In March, the Corporation cancelled two routes due to low demand and opened two new routes as part of the ongoing enhancement of West Rail and Light Rail feeder services. The Corporation outsourced one residential route to Sun Bus Limited in August.

The Corporation upgraded and expanded its fleet during the year, taking possession of the remaining second-hand buses from an order of 53 it placed in late 2004. Thirty-nine of the buses replaced non air-conditioned buses, while the remaining 14 were used to open new routes or improve service levels on existing routes. The entire 143 vehicle KCR bus fleet is now air-conditioned.

> Service Targets and Achievements

	2005 Yardstick	2005 Performance
> **Bus**		
Service delivery	99%	99.75%
Reliability: number of trips per failure	1,300	3,320

The Corporation tailors KCR Bus services to meet passenger demand for feeder services for its railways.

Looking Ahead

The Corporation will continue to focus on increasing West Rail ridership and improving the connectivity, accessibility and integration of its North West New Territories transport network in 2006.

In 2005 the Corporation commissioned a study on Light Rail's long-term business strategy in anticipation of the October 2006 expiration of the restrictions imposed on franchised bus operations in the Light Rail Transit Service Area. The consultant submitted the report at the end of 2005, and the Corporation will take the recommendations into account and consult the Government as it develops its long-term strategy for Light Rail during the coming year.

New Extensions and Future Projects

The Corporation is planning and building the next generation of Hong Kong's rail infrastructure, including the Lok Ma Chau Spur Line.

"The KCR network is growing along with us."

New Extensions and Future Projects

In 2005 the Corporation began construction of the Kowloon Southern Link, which will connect East Rail and West Rail in Tsim Sha Tsui, and substantially completed civil construction works on the Lok Ma Chau Spur Line, paving the way for the installation and testing of railway systems in 2006.

Lok Ma Chau Station will be connected to the Mainland side of the boundary, and the Shenzhen Metro, by a two-level pedestrian bridge.

New Extensions

These new projects, one just beginning and the other nearing completion, represent historic breakthroughs for Hong Kong's rail service. The Lok Ma Chau Spur Line will provide Hong Kong's second rail boundary crossing with the Mainland, nearly a century after East Rail entered service in 1910, while the Kowloon Southern Link will integrate East Rail and West Rail, creating a unified rail network.

Lok Ma Chau Spur Line

By the end of 2005, concrete structures for the 7.4-kilometre Lok Ma Chau Spur Line were substantially complete and the project had moved from the civil construction stage to the installation of railway systems.

Construction and Railway Systems Works

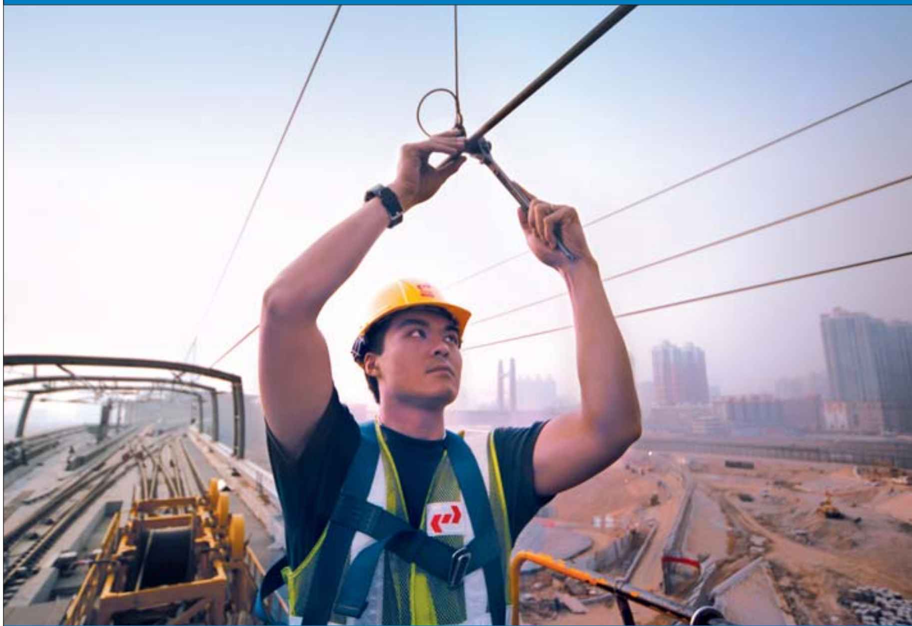
Civil construction works on the five-kilometre tunnel section in 2005 included the breakthrough of the northbound bored tunnel in April, and the completion of the cut-and-cover tunnel structures at Kwu Tung in October, which marked the substantial completion of the structural works for the entire tunnel section. Electrical and mechanical works such as the installation of fire mains and trackside lighting were 85% complete at the end of the year.

All parapet panels along the two-kilometre viaduct section of the Spur Line were installed early in the year, completing the structural work on the viaducts. Trackside works were underway and on schedule at the end of 2005.

Lok Ma Chau Station, the four-storey cross-boundary terminal building that will house the railway, customs and immigration facilities was topped out in April, and the structure of the passenger bridge linking the Station to Shenzhen was completed in November. Building services installation and architectural fitting out works were 84% and 80% complete respectively at the end of the year.

Substantial progress was made on all railway systems works during 2005. All down line and up line tracks on the viaduct section were laid, and works trains began installing trackside cabling and equipment.

New Extensions and Future Projects



The Lok Ma Chau Spur Line is on track for commissioning in 2007.

The overhead line has been installed along the viaduct and at the terminal building, and partial acceptance tests were underway by the end of the year.

Ecological Enhancement Area

The Environmental Committee, composed of members from the Corporation and several environmental groups, met regularly in 2005 to review and monitor the Corporation's environmental performance on the project.

Work on the Lok Ma Chau Ecological Enhancement Area was 90% complete, and the remaining re-profiling and planting work in the main marsh area will be finished in mid-2006. The reed-planting programme to enhance wastewater polishing was completed, while the fishpond restoration works under the viaduct section progressed smoothly.

Kowloon Southern Link

The Corporation began construction work on the Kowloon Southern Link in November. The 3.8-kilometre railway will extend West Rail from Nam Cheong Station to East Rail's East Tsim Sha Tsui Station via a new intermediate station to be built at West Kowloon.

Upon completion of the HK$8.3 billion project in 2009, the public will be able to travel between Tin Shui Wai and Tsim Sha Tsui in about half an hour, without having to change trains.

Approval Process, Contracts and Commencement of Construction

In late 2004 the Corporation amended the Kowloon Southern Link Railway Scheme in response to views received during the gazettal period, and the Government gazetted these proposed amendments for public comment in January 2005. The Environmental Protection Department issued the Environmental Permit on 3 May 2005 and the Chief Executive in Council's authorisation of the project under the Railways Ordinance was gazetted on 24 June 2005.

Civil works for the railway were packaged into three design and build contracts, which the Corporation awarded on 1 August 2005. The contracts, with a combined value of about HK$3.1 billion, were awarded in conformity with World Trade Organization procedures on government procurement. Construction commenced in November following a formal groundbreaking ceremony.

Community Involvement

Tsim Sha Tsui's dense concentration of shops, hotels, restaurants and cultural facilities makes it one of Hong Kong's premier shopping and tourist destinations, and the Corporation is working closely with businesses in the area to minimise disruption to the area during the construction process.

The Kowloon Southern Link will run entirely underground, and in order to keep disturbances to a minimum, the Corporation will employ the less-disruptive underground tunnel boring method for most of the tunnel running under Salisbury Road and the entire tunnel under Canton Road.

The Corporation has established three Community Liaison Groups for the Kowloon Southern Link to ensure that all parties affected by the project will be informed and involved throughout the construction process. In addition, the Corporation has set up a Community Liaison Office at the site office on Canton Road to respond to enquiries and comments from the public.

Future Projects

In February 2006 the Government asked the Corporation to proceed with further planning for the Northern Link and the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link (ERL) as a combined project.

Upon completion of the project, the northern sections of East Rail and West Rail will be linked, and Hong Kong will be directly connected to the Mainland's national express rail network.

The Corporation also stands ready to move ahead on the Shatin to Central Link, which would extend the Corporation's network to South East Kowloon and Hong Kong Island.

Along with the two new railways already under construction, these projects represent the future of Hong Kong rail travel as outlined in the Government's Railway Development Strategy 2000.

The Northern Link/Express Rail Link Project

The Northern Link section of the project will extend the Corporation's rail network from West Rail Kam Sheung Road Station to Lok Ma Chau. A natural extension of the network, it will provide a cross-boundary link for West Rail, and by joining the northern sections of West Rail and East Rail will create a new railway corridor between the North East and North West New Territories.

The 30-kilometre long Hong Kong section of the ERL will largely run on lines shared with the Corporation's other railways. It will originate from a new terminus at West Kowloon and run along the Kowloon Southern Link alignment, then the section of West Rail between Nam Cheong Station and Kam Sheung Road Station, then along the Northern Link, before branching off at San Tin on a dedicated track that will connect to the Mainland section of the ERL at the boundary at Huanggang.

The request to proceed with further planning of the project followed the submission of the Corporation's Northern Link Project Proposal and the Study Report on the Express Rail Link, in June and July 2005 respectively, and a supplementary report on implementing the proposed Northern Link and Express Rail Link as a single project submitted in August 2005.

Shatin to Central Link

In 2002 the Corporation won the bid to plan, build and operate the Shatin to Central Link, and in 2004 it submitted the Draft Final Proposal to the Government. All comments received from the Government were addressed in 2005.

The Draft Final Proposal included the extension of East Rail across Victoria Harbour to Hong Kong Island and the extension of Ma On Shan Rail to West Rail via East Kowloon. The final design and implementation of the Link are subject to the decision of the Government.

Looking Ahead

The Lok Ma Chau Spur Line is scheduled to commence passenger operations in early 2007, and 2006 will thus be a crucial year in terms of completing works and rigorous testing and commissioning procedures.

Another focus in 2006 will be completing the necessary statutory inspections, including those by the Fire Services Department, Buildings Department and the Hong Kong Railway Inspectorate.

The civil construction works for the Kowloon Southern Link will be in full swing in 2006, with tunnel boring works scheduled to commence towards the end of the year.

Safety

The safety of its passengers, staff and contractors is of paramount concern to the Corporation, and the Corporation's safety standards and management practices are in line with best practices in the mass transit industry. In 2005 the American Public Transportation Association's comprehensive audit of the Corporation's safety management programme determined that KCRC was "clearly committed to safety excellence at all levels of the organisation".

A major 2005 independent safety audit found that KCRC "has developed a proactive safety culture" and "industry leading practices".

KCRC conducts regular drills with emergency service agencies to hone emergency preparedness, organises passenger safety promotions, and works to continuously improve its safety and risk management performance.

Safety Audit System

The safety of the Corporation's assets and systems, as well as that of its staff and the environment, is managed by a comprehensive safety audit system. Safety management is overseen directly by senior management, which closely monitors all safety-related procedures. The Corporation regularly conducts quality and safety audits and risk assessments as required by law.

The Corporation is also a member of the Rail Safety Audit Program of the American Public Transportation Association (APTA), which conducts in-depth audits in a three-year cycle.

In March 2005 an APTA team of experts in safety and security management, engineering, and operations conducted a full-scale safety audit of the Corporation. The audit was based on APTA's 24-element System Safety Program Plan, which builds on the internationally recognised OHSAS 18001 safety management system and includes railway specific safety critical issues.

The audit team reviewed the Corporation's safety and security management system, safety culture, operational rules and procedures, accident investigation, training, equipment maintenance and repair, security efforts and station operations.

APTA's report found that the Corporation "has developed a proactive safety culture that is embedded in all employees' core day to day responsibilities" and that it "has developed industry leading practices within the scope of critical safety elements including hazard management, safety training, data analysis, engineering analysis and emergency preparedness".

The audit team also suggested several ways in which the Corporation could act to continually improve safety and security management and further enhance railway operation and engineering effectiveness. In May the Transport Division completed a comprehensive action plan to implement these recommendations.

Maintenance

The Corporation's inspection and maintenance regime is in line with international standards and includes strategies such as preventive maintenance, reliability-centred maintenance, constant monitoring of the performance of components and equipment, and lifecycle analysis.

As part of its continual review of maintenance practices, the Corporation asked the APTA experts

Safety

to conduct a Technical Assessment evaluating its maintenance practices and operating performances. The Assessment confirmed that the Corporation's maintenance practices and operating performances are consistent with best practices in the mass transit industry.

East Rail

The number of passengers and members of the public injured per million passenger journeys was 0.74 in 2005, the same level recorded in 2004.

Measures to enhance passenger safety included adding studded flooring at the entrances of refurbished trains, the installation of bollards at escalator landings to prevent passengers with bulky luggage from using the escalators, and enhancing the visibility of platform edges.

The Corporation conducted a series of drills and joint exercises in conjunction with the police, the Fire Services Department and other emergency service agencies to maintain emergency preparedness and promote coordination and communication during rescue operations.

In Ma On Shan Rail's first year of operation, the number of passengers and members of the public injured per million passenger journeys was 0.46.

West Rail

The number of passengers and members of the public injured per million passenger journeys was 0.55, an improvement of 30% from the level of 0.79 recorded in 2004. Programmes to further enhance safety included increasing the frequency of safety announcements in stations and the deployment of additional staff to advise passengers on the safe use of escalators. Bollards were installed on the entry landings of some escalators to deter passengers with bulky luggage from using the escalators, directing them to lifts instead.

Light Rail

The number of passengers and members of the public injured per million passenger journeys was 0.17, slightly higher than the 2004 rate of 0.14.

Efforts to further reduce accidents included the installation of bollards at the pedestrian crossings of 35 Light Rail stops and junctions and the installation of platform gap fillers at 50 Light Rail platforms.

Construction Safety

The Corporation has set and continues to achieve safety and health standards for its construction projects that better the established Hong Kong standards. The Corporation was the first organisation in Hong Kong to introduce an internationally recognised independent safety auditing scheme that links audit results to contractors' milestone payments.

In 2005, the Lok Ma Chau Spur Line project achieved a very low incidence rate (reportable accidents per 1,000 workers) of 11.83, well below the Hong Kong average of 60.3 (2004) and the project goal of below 25. The excellent record was the result of a coordinated programme by the Corporation and contractors to ensure a safe working environment and the fostering of a "Zero Accident" culture.

Safety and Health Management

The Corporation works to continuously improve its safety and risk management performance by setting realistic and achievable objectives, monitoring and measuring performance, working closely with contractors, and periodically auditing and reviewing its safety and risk management programmes.

The Corporation's staff accident rate has decreased steadily in recent years. In 2005, the staff accident rate was 5.4 accidents per 1,000 employees, well below the Hong Kong average of around 18 accidents per 1,000 employees recorded in 2004.

During the year, 59 station staff were certified as Pre-hospital Trauma Life Support Providers after attending a course jointly offered by the American College of Surgeons Hong Kong Chapter, the Hong Kong St. John Ambulance Association and the National Association of Emergency Medical Technicians. The course trained staff in the assessment of trauma patients, examination, diagnostic and specific pre-hospital trauma intervention skills. After passing a stringent written and practical examination, the staff were certified by the National Association of Emergency Medical Technicians. The Corporation will send staff to the training on an ongoing basis in order to be able to provide qualified emergency medical assistance to passengers if needed.

In addition to job-specific safety training, the Corporation regularly conducted general safety training in areas such as fire safety, hazard management and construction site safety, and held regular talks on common workplace health issues.

In response to the threat of an avian flu epidemic, the Management Committee approved a Response Plan for Special Medical Situations and established a Corporate Response Team to coordinate response actions. The plan is designed to control the health risk to the Corporation's customers, staff and contractors, and to maintain business operations.

Regular safety and maintenance checks are key elements of the Corporation's safety processes.

In October, the Corporation launched an Occupational Injury Rehabilitation Programme that provides rehabilitation services to injured staff. The programme seeks to facilitate an optimal recovery and a safe return to work for employees injured in the course of employment. Managed by a team of rehabilitation professionals, it is available free-of-charge to all staff on a voluntary basis.

Safety Education

The Corporation organised safety campaigns to improve passenger safety on KCR railways in May and October.

Students kicked off the May campaign, which included a media briefing, radio programmes, and media and print publicity, by assembling a giant jigsaw puzzle featuring safety messages. The innovative October campaign featured a comic drawing competition in which passengers submitted comics promoting safety messages. The competition enhanced passengers' awareness of safety in an eye-catching way, and the winning entries were compiled in a safety booklet.

Property Development and Other Businesses

The large-scale renovation of the Ocean Walk shopping centre in Tuen Mun is part of the Corporation's programme to maximise commercial revenue.

Property Development and Other Businesses

In 2005 the Corporation returned to the property development market following a two-year Government moratorium on land sales. Though the tendering process for several projects was delayed, the Corporation awarded the tender for the major project above Ma On Shan Rail Wu Kai Sha Station, and invited expressions of interest in the Tai Wai Maintenance Centre project, which will be tendered in early 2006. The development of projects along West Rail and Ma On Shan Rail is scheduled to continue over the next several years.

Pre-sales of flats in the Ho Tung Lau (Site A) development project in Fo Tan will begin in 2006.

Responsibilities

The Corporation undertakes property development to generate income to fund improvements to the existing railway network and to secure a permanent and increasing ridership for the Corporation's railways.

The Corporation develops high-quality properties jointly with established property developers to leverage on their expertise and experience.

Property Development Programme

In 2005 the Corporation implemented the property development programme for sites along West Rail and Ma On Shan Rail that had been delayed by the two-year Government moratorium on property sales. The Corporation invited expressions of interest in four projects during the year, and successfully awarded the tender for the Wu Kai Sha project. Although tendering of several other projects was delayed due to the need to carry out public consultation, the Corporation accelerated the development schedule for other projects to fill the gaps.

Property Development Sites

Light Rail
1. Tin Shui Wai Light Rail Terminus

West Rail
1. Nam Cheong
2. Kwai Fong
3. Tsuen Wan West
4. Pat Heung Maintenance Centre
5. Kam Sheung Road
6. Yuen Long
7. Long Ping
8. Tin Shui Wai
9. Tuen Mun

East Rail
1. Hung Hom Mass Transportation Centre
2. The Metropolis
3. Ho Tung Lau (Site A)
4. Fo Tan

Ma On Shan Rail
1. Tai Wai Maintenance Centre
2. Tai Wai Station
3. Che Kung Temple
4. Wu Kai Sha

Property Development and Other Businesses

> Property Development

> Developed properties	Residential floor area (sq m)	Commercial floor area (sq m)
Pierhead Garden, Tuen Mun	91,400	9,984
Sun Tuen Mun Centre, Tuen Mun	200,000	14,000
Manlai Court, Tai Wai	43,850	420
Hanford Garden, Tuen Mun	88,000	3,200
Sun Yuen Long Centre, Yuen Long	66,430	25,880
Royal Ascot, Sha Tin	271,656	10,000
Mong Kok Station	–	149,590
The Metropolis, Hung Hom	–	132,218*
Sub-total	**761,336**	**345,292**
> **Property under construction**		
Ho Tung Lau (Site A)	120,900	2,000
Wu Kai Sha	168,650	4,000
Total	**1,050,886**	**351,292**

* *Including 35,034 square metres of serviced apartment units*

West Rail priority property sites

Nam Cheong	(4.62 hectares)
Yuen Long	(3.46 hectares)
Tuen Mun	(2.66 hectares)
Tsuen Wan West	(9.41 hectares)
Long Ping	(2.61 hectares)
Tin Shui Wai	(3.48 hectares)
Kam Sheung Road	(9.85 hectares)
Pat Heung Maintenance Centre	(24 hectares)
Kwai Fong	(1.92 hectares)

Ma On Shan Rail priority property sites#

Wu Kai Sha	(3.41 hectares)
Tai Wai Maintenance Centre	(7.06 hectares)
Tai Wai Station	(4.85 hectares)
Che Kung Temple	(1.81 hectares)

About 830,850 square metres of gross floor area will be built on these four sites, about 92% of the gross floor area will be used to create 10,972 residential flats between 2008 and 2013.

In June the Corporation awarded the tender for the joint venture Wu Kai Sha project to Shine Harvest International Limited, a wholly owned subsidiary of Sino Land Company Limited. Seven tenders were received for the 3.4-hectare site above the Public Transport Interchange at Ma On Shan Rail Wu Kai Sha Station. Seven residential blocks providing 2,528 residential flats will be built in three phases, with the first phase scheduled for completion in 2008.

In August the Corporation received 10 expressions of interest for the joint venture project at West Rail Tuen Mun Station. However only one developer submitted a tender after the project's land premium, set by the Government, was criticised as being too high. After carefully reviewing the tender, the Corporation announced in December that it would re-tender the project after renegotiating the land premium with the Government in view of recent market changes.

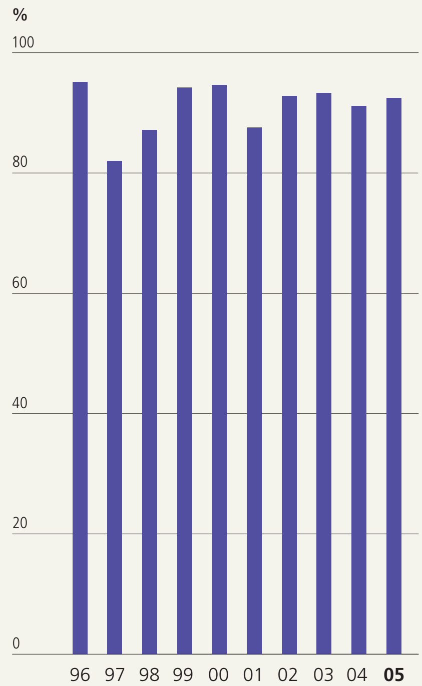
In November, the Corporation received 24 expressions of interest in the Tai Wai Maintenance Centre project. Twelve residential towers containing 4,304 flats will be built above the Corporation's Tai Wai Maintenance Centre. The project which will be tendered in the first quarter of 2006 has been divided into two joint venture packages, with the option of allowing tenderers to submit a combined bid for the two packages.

Development Projects

The Ho Tung Lau (Site A) joint venture project remained on schedule in 2005. Ten 37 to 40 storey residential towers are being built on a two-level podium, providing approximately 1,351 residential units and 290 car park spaces. The foundation works and detailed design of the building structure were substantially complete by the end of the year, and pre-sales of the residential units are scheduled to begin in the second quarter of 2006. The Corporation's partner in the project is Full Fair

The Corporation will invite tenders for several property development projects along West Rail and Ma On Shan Rail in 2006.

KCRC's Property Occupancy Rate – Station Commercial Premises, Commercial Offices and Shopping Arcades



Limited, a subsidiary of Sino Land Company Limited. The Corporation will manage the development once it is completed in 2007.

Linear City Research Project

Initiated by the Corporation and research teams from the Chinese University of Hong Kong and the University of Hong Kong, the innovative multi-disciplinary Linear City Research Project has examined the "linear city" running along railway alignments.

Module Two of the project was completed in October, and in line with overall trends in Hong Kong, the preliminary findings noted a demand for greater commitment towards sustainable community development and calls for better environmental, social and governmental thinking in the formulation of policies.

Other findings that will influence the Corporation's development programme include the call for an emphasis on community-integrated development and a commitment to sustainable development, and the view that rail-based service is an engine of economic development in the New Territories.

Commercial Property and Other Businesses

Hong Kong's economy recovered rapidly in 2005, resulting in an active leasing market. The occupancy rate of KCR commercial premises in stations, commercial offices and shopping centres was 92% at the end of 2005, and renewal of commercial premises achieved a rental increment of 37% during the year. The residential and office rental markets also improved substantially, and the residential units and office buildings held by the Corporation for investment purposes were fully occupied in 2005.

Property Development and Other Businesses

The increasing diversity of shops in the Corporation's stations offers passengers more choice and convenience.

To maintain the value and competitiveness of its investment portfolio and generate recurrent revenue, the Corporation has implemented a maintenance programme that includes extensive renovation works at its shopping centres. During 2005, the Corporation carried out large-scale renovation works at Ocean Walk (formerly known as Pierhead Plaza), a 10,000-square metre shopping centre located adjacent to the Tuen Mun Pier. Work commenced in June and was largely completed by the end of the year.

Prospective tenants have offered positive feedback on the shopping centre's new layout and façade and the Corporation anticipates that the renovated centre will have an improved tenant mix. The renovated centre was around 90% leased out when it re-opened in February 2006.

To further maximise rental revenue, the Corporation released an additional three floors of prime office premises at Citylink Plaza for commercial leasing in 2005. Planning and design work on the major Sha Tin Expansion Project also commenced during the year. The project will provide an additional 8,000 square metres of retail space in Sha Tin Station and Citylink Plaza. It is scheduled for completion in 2009.

Revenue from station trading increased by 28% during the year, primarily as a result of the improved economy. Along East Rail, the 148 additional shops added by the opening of the Tsim Sha Tsui Extension and Ma On Shan Rail were 86% occupied by the end of 2005. The expiration of the Corporation's rental relief programme for station shops along West Rail resulted in the resumption of full rents in some locations.

The Corporation continued to offer passengers more choice and convenience by diversifying the trade-mix found in its stations and introducing a greater variety of food and beverage outlets, branded shops and social service facilities.

Duty free sales at Lo Wu and onboard through trains continued to grow during the year, contributing 8% more revenue in 2005 than 2004.

The Corporation's efforts to increase commercial exhibition business resulted in a 38% revenue increase in this sector during the year as more exhibitors were attracted by the high exposure of the exhibition sites and chose to market their services and products at stations.

In partnership with Hong Kong Cable News Express Limited, a subsidiary of i-CABLE Communications Limited, the Corporation launched Hong Kong's first on-train quasi real-time audio-visual system, Newsline Express, in August. In addition to providing current news, the medium is an effective tool for delivering advertising and promotional messages and has attracted clients from a variety of sectors.

The strong Hong Kong economy, the successful launch of Newsline Express, the increasing demand for in-train sticker advertising and the Corporation's first use of large T-shaped outdoor panel advertising in Hung Hom all contributed to growth in advertising revenue and quality. Advertising revenue grew 28% compared with 2004.

Looking Ahead

The Corporation will focus on moving the property development programme forward in 2006 for properties along West Rail and Ma On Shan Rail. Four projects are scheduled to begin the tendering process. Pre-sales of residential units in the Ho Tung Lau (Site A) Project will also get underway in 2006.

The Corporation will continue to expand its property management services in 2006. Such services will include its shopping centres and station shops.

> Property Services

> Property management	Commercial floor area (sq m)	Units of car parking space	Number of residential flats managed
Citylink Plaza	24,954	–	–
KCRC Hung Hom Building	5,576	–	–
Pierhead Garden	9,984	168	1,432
Sun Tuen Mun Centre	14,000	421	3,500
Hanford Garden	3,200	237	1,504
Royal Ascot	10,000	2,121	2,504
The Metropolis	23,466	438	662
Trackside Villas	–	72	252
Total	**91,180**	**3,457**	**9,854**
> Leasing of office buildings			
Citylink Plaza	21,909		
KCRC Hung Hom Building	5,576		
Total	**27,485**		
> Leasing of shopping centres			
Citylink Plaza	3,045		
Ocean Walk (formerly Pierhead Plaza)	9,984		
Sun Tuen Mun Shopping Centre	14,000		
Shops in Manlai Court	420		
Hanford Plaza	3,200		
Plaza Ascot	10,000		
Total	**40,649**		
Leasing of residential units	272 units		

> Station Commercial Activities

- Duty-free business
- Restaurant and rail-bar business
- Public car-parking business
- Park and ride service
- Leasing of retail shops
- Leasing of office accommodation and store rooms
- Automatic teller machines
- Self-service machines and terminals
- Location film shooting
- Estate management and building maintenance services
- Leasing of retail sales kiosks/counters

> Advertising and Promotions

- Poster advertising
- Large outdoor advertising displays
- Feature advertising
- Promotional free standing displays
- Distribution of free newspapers
- Commercial exhibitions
- Promotional activities
- Passenger Information Display System – Newsline Express

> Telecommunications Services

- Public payphones
- Mobile phone coverage in stations, tunnels and along railway tracks
- Optical fibre leasing

Corporate Support

Training and other corporate support functions play vital roles in maintaining and enhancing the Corporation's image and the capabilities of its workforce.

"Team spirit in action."

In 2005 the Corporation continued to develop programmes to improve staff satisfaction and welfare. During the year the Corporation implemented a new leadership development programme, increased training options and enhanced training technologies, introduced an integrated staff redeployment programme and launched several new channels of communication with staff.

Enhancing the quality of customer service is one of the major goals of the Corporation's staff training programme.

Building Leadership

The Corporation's new leadership development and management succession programme, introduced in February, matches personal competencies to business goals and provides a diverse set of learning solutions such as workshops, external education, mentoring programmes and regular assessment and feedback, that are reinforced by a range of support systems.

Staff Training

The Corporation continued to strengthen staff training programmes in 2005, and each KCRC employee received an average of seven days of training during the year. Training evolved to meet changing needs, and new programmes and workshops were developed to help individuals and departments align with business needs. Over 1,000 staff received Putonghua training.

Technology also made training accessible to more employees. For example, more than 1,300 staff voluntarily participated in self-paced e-learning and many others attended training seminars or video sessions. Traditional classroom training was augmented by pre- and post-training activities that better ensured the transfer of learning into the workplace.

Staff Communications

There are numerous channels, including staff consultative committees, newsletters and staff unions, through which staff and the Corporation's management exchange views.

In 2005 the Corporation introduced several new channels of communication, including town hall briefings in which senior management spoke to staff and answered questions (the briefings were also broadcast live over the corporate intranet so other staff could participate), an employee hotline, and a dedicated website that provides useful information to former employees.

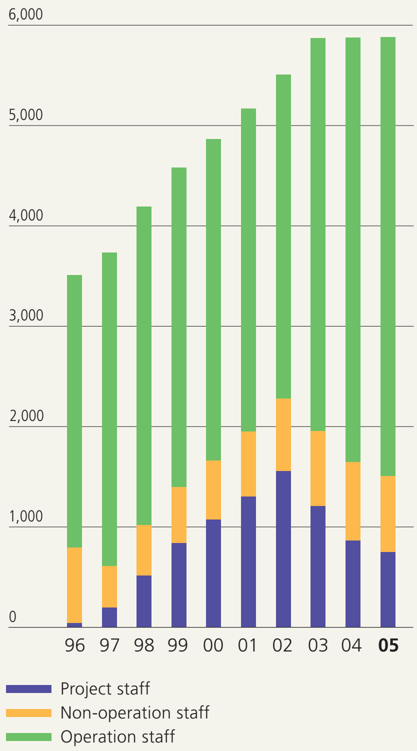
Staff Relations and Wellness

The Corporation's changing business needs in recent years have led to the redeployment of more staff. This trend continued in 2005, as over 200 staff were redeployed due to the deferment of the Shatin to Central Link project, the repositioning of the freight business and the launch of the KCR Railbus - Disneyland service.

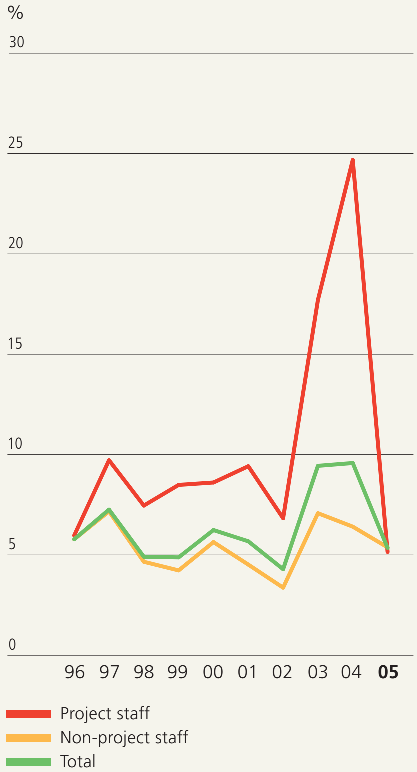
To better serve both staff and business needs the Corporation developed and launched an integrated staff redeployment programme in 2005. It involves giving early notice to affected staff, personal coaching and counselling, as well as career transition training and outplacement counselling when necessary, and a framework for staff redeployment.

In October the Corporation launched an Occupational Injury Rehabilitation Programme that provides free rehabilitation services to staff injured at work. To promote staff wellness, the Corporation opened a new health corner and relocated a clubhouse during the year, providing opportunities for staff to exercise and relax near their place of work.

Staff Numbers



Staff Turnover



Communication with its many stakeholders, which include its passengers, the Government, community groups and Legislative and District Councillors, remained a priority for the Corporation during the year, and a range of programmes were conducted to solicit feedback from stakeholders and share information about the Corporation's plans and services. The Corporation also continued to participate in the community in many ways in 2005, launching a major community service campaign and further expanding its volunteer programme.

The KCRC Destination Care campaign is one way in which the Corporation is serving the needs of our community.

The Art Corner at East Tsim Sha Tsui Station displays works by local artists and students.

Passengers and Corporation management chat face to face at a KCRC Café session.

Communication with Stakeholders

The Corporation devoted extensive efforts to enhancing the speed, transparency and effectiveness with which it shared information about KCRC services, future plans and railway incidents in 2005. Various channels of communication with the Corporation's stakeholders were employed and these efforts resulted in favourable feedback from stakeholders as well as positive reports on the Corporation in the media.

During the year the Corporation arranged a number of visits to its facilities, including maintenance centres, stations, control rooms and construction sites. These visits enabled media representatives and Legislative and District Councillors to gain a first-hand understanding of the Corporation's new systems and safety and maintenance procedures, its handling of incidents, and the progress of construction works, all of which are topics of great importance to both the Corporation and the public.

Public consultations continued throughout 2005, gathering public opinion on, and raising public awareness of, matters including the railways under construction, the re-organisation of bus routes, noise along railways, and ticketing and marketing initiatives. Legislative and District Councillors and community leaders were consulted on these issues and others in the effort to obtain their support through accurate, timely and effective communication.

Consultations with passengers during the year included five meetings of the Passenger Liaison Groups for East Rail and West Rail/ Light Rail, at which the Corporation's senior managers and members of the public discussed various service related matters.

Four KCRC Café sessions enabling passengers to meet the Corporation's management team face to face were also held at locations along the East Rail and West Rail/Light Rail alignments. In order to familiarise the public with the Corporation's services, visits and talks were arranged with schools, tertiary institutions, community groups and charity bodies.

The Public Consultation Group on Railway Operations, composed of KCRC Managing Board members and senior management, the chairmen of the Traffic and Transport Committees of the District Councils served by KCRC and representatives from Passenger Liaison Groups also met regularly during the year.

Children and members of the Corporate Volunteer Team alike enjoy educational field trips to museums.

New Railway Projects

Starting with West Rail, the Corporation has formed Community Liaison Groups along the alignments of all new railway projects to promote public understanding and acceptance of new railways.

The Community Liaison Groups in San Tin and Sheung Shui were key consultation and briefing channels in 2005, discussing the progress of the Lok Ma Chau Spur Line and concerns about the impact of construction works. Following the completion of the tracks for the southbound line, both groups were invited to travel from Sheung Shui to Lok Ma Chau Station on a works train.

The Community Liaison Office in Sheung Shui also continued to serve as an effective communication channel with the communities along the Spur Line, providing information on the project to area residents and handling their enquiries and complaints.

Before work on the Kowloon Southern Link began in November, the Corporation organised three Community Liaison Groups for community stakeholders. The Corporation has also established a Community Liaison Office for the project at the site office on Canton Road.

Publicity

The Corporation produced an updated version of its corporate video covering latest developments, and in May the passenger newsletter was revamped and renamed Funride@kcr. In addition to news, Funride@kcr also carries articles on sightseeing and other recreational opportunities along the rail network, and coupons valid at shopping malls managed by the Corporation.

A Good Passenger Campaign intended to educate passengers on how to be considerate while travelling on KCR trains, and radio advertising and phone-in programmes were also used to spread safety and courtesy messages.

To promote the Corporation's culture of service excellence, a "Go the Extra Mile" (GEM) campaign was launched in July. Publicity activities to enhance awareness of the GEM spirit among staff and the public included the setting up of a dedicated intranet site, publishing regular GEM columns in the staff magazine, and production of a poster displayed at Corporation premises and stations.

Contributing to the Community

The KCRC Destination Care campaign, launched in June, was the focal point of the Corporation's 2005 community involvement programmes. Developed to support Government initiatives to help the financially disadvantaged, the Destination Care programme consisted of activities that offered educational and self-development opportunities to underprivileged young people.

Organised and run by the Corporate Volunteer Team, the flagship Educational Tour Programme saw volunteers lead groups of children from low-income homes on free visits to museums in Tsim Sha Tsui. More than 300 children and 80 volunteers had participated in the programme by the end of the year. The programme received a Merit Award in the Corporate Volunteer Service Project Competition 2005, organised by the Social Welfare Department.

The Corporate Volunteer Team made meaningful contributions to the community throughout the year, and the more than 270 members devoted over 2,500 hours to volunteer activities involving the elderly, young people, and the disabled, and also actively participated in environmental protection programmes.

The Corporation as a whole continued its longstanding support of charitable causes, joining numerous Community Chest fundraising activities, other charity events and races, and environmental awareness programmes. It also donated used spectacles, computers, uniforms and clothing, as well as surplus Chinese New Year treats, to charitable organisations.

The Corporation's interest in promoting public interest in the arts also continued in 2005. In March the Corporation unveiled the KCR Art Corner, which features works by local artists, in East Tsim Sha Tsui Station. Later in the year, the KCR Train Library encouraged passengers to take up reading as a leisure activity. The self-serve library is located at Sha Tin Station and lends books donated by Corporation staff and the public.

The Corporation maintains regular dialogue with its stakeholders, including the press, legislators and Government officials.

Corporate Support > Quality Management

The major focus of the Corporation's quality management programme in 2005 was the drive to further enhance the Corporation's culture of service excellence.

Staff Change Champions are helping enhance customer service and innovation throughout the Corporation.

Following the expansion of KCRC's network with the successful opening of both the Tsim Sha Tsui Extension and Ma On Shan Rail, and the increase in passengers, the Corporation decided to introduce a new initiative centred on furthering its culture of service excellence.

"Go the Extra Mile" Campaign

In July, the Corporation launched the "Go the Extra Mile" (GEM) campaign. The campaign renewed the Corporation's emphasis on customer care and involved a comprehensive and integrated series of programmes focused on service excellence.

The GEM campaign is overseen by a Steering Committee chaired by the Corporation's Chief Executive Officer (Acting), and five working teams lead the Corporation's drive to achieve the GEM goals.

The Reliability Team worked to improve service reliability by identifying various measures to minimise service disruptions due to equipment failures.

The Passenger Information and Feedback Team focused on developing better ways of providing travel information to passengers and obtaining passenger feedback.

Charged with seeking ways to foster a more proactive service culture, the Customer Care Team produced a Best Practice Guidebook for all frontline staff that defines excellent service standards and how to achieve them. It covers all customer service job functions in both domestic and intercity services, involving ticket, platform and station staff, as well as drivers and maintenance staff. The guidebook will be used to train 2,300 staff in GEM service behaviours.

The Publicity Team communicated progress and improvements made as a result of the GEM campaign. The team conducted surveys on customer perceptions, and organised a programme of speaking events focusing on service excellence.

The Change Management Team developed a set of GEM behaviours and competencies. To enhance the linkage between GEM behaviour and professional recognition and reward, the team also revised the staff performance appraisal criteria to cover GEM competencies.

As part of the GEM campaign some 130 Change Champions were sent on a two-day intensive workshop on change management and overcoming barriers to achieve breakthroughs. And to further promote a culture of service excellence, examples in which staff exemplified the GEM spirit appear regularly in the staff newsletter and are shared throughout the Corporation.

Various GEM activities to encourage staff to go the extra mile in serving customers will continue in 2006.

Improving Management Systems

In April, the Transport Division was certified to the new ISO 14001:2004 version of the international environmental management system standard. It also combined its five previously separate ISO 14001:1996 environmental certificates, and extended their scope to include West Rail, Ma On Shan Rail and the Tsim Sha Tsui Extension.

The Capital Projects Division restructured and streamlined its quality system documentation. The new system improves control and efficiency and allows greater flexibility, while the introduction of practice notes as guidelines for implementing procedures significantly reduced the number of procedures.

Encouraging and Rewarding Innovation

Ideas-hub, the Corporation's revised staff suggestion reward system, received over 100 suggestions in its first year. In July, more than 40 staff took part in an Ideas Café, viewing a presentation on wireless technology before brainstorming possible applications within the Corporation. The session generated many useful ideas and additional Ideas Cafés have been planned.

Outstanding individuals and teams were also recognised and rewarded for their significant contributions to the Corporation: three individuals and four teams won the Chairman's Award, and one individual and two teams received Chairman's Commendations. The winning accomplishments included developing software to better estimate train journey times during incidents, instances of outstanding customer service and dedication to the Corporation, and ideas that resulted in significant cost and energy savings.

The Corporation continued to share its successes with others and participated in the annual Hong Kong Quality Improvement and Experience Sharing Convention, where the Corporation and a host of Hong Kong's leading companies gathered to share their successes and learn from each other's experiences.

The Environment

The Corporation's Ecological Enhancement Area near Lok Ma Chau is a landmark achievement in environmental impact management in Hong Kong.


"Environmental awareness makes life better for all of us."

The Environment

The Corporation further enhanced its commitment to caring for the environment in 2005. Under the leadership of the Corporate Environmental Steering Committee, the Corporation launched a major environmental campaign, achieved the waste reduction targets it set for itself under the Government's Wastewi$e scheme, and put a number of other wide-ranging environmental initiatives in place.

KCRC's railways incorporate numerous environmental and noise reduction features and technologies.

Green Ambassadors worked throughout the year to spread the environmental message.

Forever Green Campaign

The Corporation's 2005 environmental programmes began in January, with the launch of the Forever Green campaign to minimise waste and save energy. At the launch ceremony the Corporation announced the 14 waste reduction targets which it had committed to upon joining the Environmental Protection Department's Wastewi$e Scheme. These targeted the minimisation of waste through the setting of clear waste avoidance and reduction targets, reuse and recycling, and the use of environmentally friendly materials.

The 14 targets, all of which were achieved, included reducing the use of paper and other office items, recycling toner cartridges and safety helmets, producing electronic instead of paper editions of documents when possible, and collecting used spectacles, computers and mobile phones.

Achieving these targets, and the Gold Wastewi$e Logo, depended on the participation of all staff, and the Corporate Environmental Steering Committee recruited 40 Green Ambassadors who worked to promote green office practices throughout the Corporation and spread the environmental message.

Other Forever Green events included a Clean Office Competition in which the judges evaluated the correct handling and separation of waste for recycling, and a drive by passengers, staff and shop tenants to collect Chinese New Year treats for redistribution to less fortunate families. In April, staff organised and ran a mini-bazaar charity sale to raise funds for the Conservancy Association.

In support of World Environment Day the Corporation participated in the Environmental Protection Department's campaign to switch off idling vehicle engines and raise office temperatures to reduce electricity consumption and carbon dioxide emissions.

Operations and Maintenance

The Corporation continued to enhance its environmental performance in its operations and maintenance practices. Power factor correction equipment has been

The Environment

Among other things, the Corporation's recycling programme extends to batteries, toner cartridges and safety helmets.

Commitment and action across the Corporation were essential to earn the Gold Wastewi$e Logo.

installed on all trains to reduce energy consumption, and the lighting and air-conditioning systems on empty trains are turned off when they travel. The Corporation's diesel locomotives and buses use ultra-low sulphur diesel and some station escalators and ticket machines are turned off during non-peak hours.

All of the Corporation's train washing plants are equipped with water recycling systems, and 85-90% of the water used is recycled. The material life of items has been extended when it is safe to do so, and by-products such as scrap metal and spent lubricant oil that can be reused are recycled or sold.

The Corporation uses energy efficient lighting and green products such as remanufactured printer toners, biodegradable track lubricant, biodegradable barrier tape, and biodegradable cleaning agents, whenever possible.

New Projects

The Corporation's construction projects continue to be managed under the three-tier system developed for West Rail and used for all new construction projects since. Environmental Impact Assessments are conducted before the new projects begin, assessing the possible environmental impacts and setting out the Corporation's mitigation measures.

Contractors' environmental management plans are reviewed by the Corporation before construction starts and their performance is monitored and audited by the Corporation's environmental specialists and independent checkers to ensure compliance with all relevant environmental laws and project requirements.

The Environmental Committee, composed of members from the Corporation and green groups including Friends of the Earth, the World Wide Fund for Nature, and the Hong Kong Bird Watching Society, continued to monitor the Corporation's environmental performance on the Lok Ma Chau project.

Work on the Ecological Enhancement Area near Lok Ma Chau Station continued throughout the year and is expected to finish in 2006. The 37-hectare recreated wetland habitat area includes fishponds, reed beds and wetlands for breeding and roosting birds. Ecological specialists have determined the effectiveness of the enhancement work and formulated management strategies tailored to different seasons or to attract specific bird species. The area continued to attract many different species of wildlife, especially birds, in 2005.

Investment and Financing Strategies

In July, the Corporation's foreign currency debt rating assigned by Moody's Investors Service pierced the Hong Kong SAR sovereign ceiling for foreign currency obligations following Moody's adoption of a new rating methodology which involved applying its joint-default analysis to government-related issuers.

Financing

No new financing was arranged in 2005 as the construction of the Shatin to Central Link was deferred pending decision by the Government. Currently, the Corporation's sources of financing include bond issues, export credit facilities and bank borrowings.

As at 31 December 2005, the Group and the Corporation had interest-bearing borrowings of HK$19,474 million, with an average maturity of four years. The average cost of borrowing was 7.29%.

Credit Rating

In July 2005, Moody's upgraded the rating of the Corporation's senior unsecured foreign currency debt from A1 to Aa3 with the adoption of a new rating methodology which involved the application, on a global basis, of its joint-default analysis to government-related issuers. This was the first time that the Corporation's foreign currency debt rating pierced the Hong Kong SAR sovereign foreign currency ceiling.

Investment

Further to taking over the management of its bond funds in 2004, the Corporation took over the management of its money market funds from two external investment managers in June 2005. As a result, all the Corporation's surplus cash is now managed internally.

As at 31 December 2005, the Group's cash and cash equivalents and investments in securities amounted to HK$3,843 million. All the funds were invested by the Corporate Treasury Department in a diversified portfolio of short-term bank deposits and fixed income instruments of investment grade quality.

Risk Management

The Corporation manages its currency and interest rate exposures with derivative instruments such as interest rate swaps, currency swaps and foreign exchange forward contracts in accordance with the Managing Board's approved hedging guidelines. These instruments have

Investment and Financing Strategies

> Credit Ratings

	2005
> Standard & Poor's	
Short-term local currency corporate credit rating	A-1+
Short-term foreign currency corporate credit rating	A-1+
Long-term local currency corporate credit rating	AA-
Long-term foreign currency corporate credit rating	AA-
> Moody's	
Short-term issuer rating	P-1
Long-term domestic currency issuer rating	Aa3
Long-term foreign currency issuer rating	A1
Senior unsecured domestic currency debt rating	Aa3
Senior unsecured foreign currency debt rating	Aa3

The Corporation's senior unsecured foreign currency debt rating assigned by Moody's has pierced the Hong Kong SAR sovereign foreign currency debt rating ceiling of A1. Otherwise, the credit ratings for the Corporation assigned by Standard & Poor's and Moody's are at the same level as those of the Hong Kong SAR Government.

> Debt Facilities and Programmes

	2005 (HK$ million)		2004 (HK$ million)	
	Drawn	Undrawn	Drawn	Undrawn
> Debt Facilities and Programmes				
Medium term note programme	8,973	14,377	8,998	14,425
Global notes	7,783	–	7,807	–
Retail notes	1,000	–	1,000	–
Export credit loan facilities	1,700	11	1,985	29
Syndicated loan facilities	–	8,000	–	8,000
Bank overdraft facilities	–	25	–	25
Letters of credit	–	20	–	20
Letters of credit for leveraged leases	–	2,273	–	2,280
Uncommitted short-term facilities	–	2,200	–	1,650
Total	**19,456**	**26,906**	19,790	26,429

been employed only for hedging purposes. Our objectives are to reduce the foreign currency exposure in respect of debt obligations by converting such obligations into either Hong Kong dollars or US dollars, and to maintain our US dollar exposure in debt obligations at no greater than 30% of total debt obligations. Moreover, we seek to limit our exposure to interest rate risk by maintaining in fixed interest rate debt between 30% and 75% of the total debt obligations.

> Investments Managed by Investment Managers and KCRC

	2005 (HK$ million)	2004 (HK$ million)
> **Investment managers**		
Fixed income portfolios	–	2,227
> **KCRC**		
Cash and cash equivalents	3,394	3,531
Funds taken over from Investment managers – fixed income portfolios	400	–
Deposits placed with custodian bank	49	2,096
Sub-total	3,843	5,627
Total	**3,843**	7,854

As at 31 December 2005, the proportion of borrowings denominated or hedged into Hong Kong dollars stood at 87% (2004: 86%).

After the repayment of certain floating rate export credit loans, the Corporation entered into three interest rate swap transactions in 2005 to bring the proportion of fixed interest rate obligations within the desired level of between 30% and 75% of the total debt obligations.

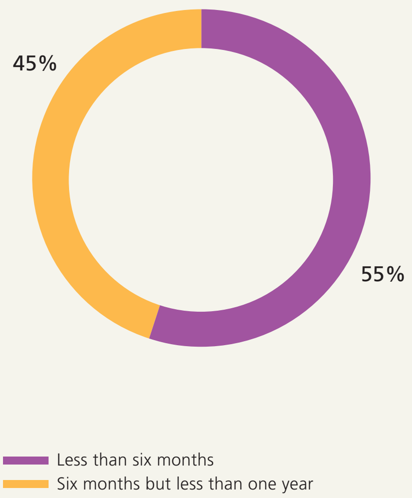
As at 31 December 2005, the proportion of fixed interest rate borrowings stood at 73% (2004: 75%).

Compliance

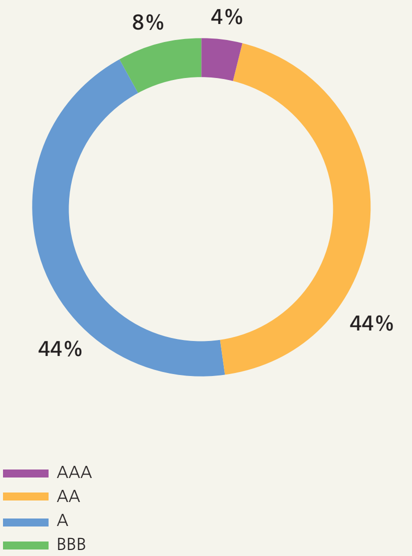
The Corporation has strived to comply with all rules and regulations of the stock exchanges and regulatory authorities that govern the listing and trading of the Corporation's debt securities.

To ensure compliance with the requirements of Section 404 of the Sarbanes-Oxley Act, the Corporation has appointed a consultant to provide assistance in developing the appropriate control documentation regarding the Corporation's internal control system over financial reporting. A Project Steering Committee and a Project Team have been formed to ensure a successful implementation of the Section 404 project.

Maturity Profile of Investments



Composition of Investments by Credit Quality



Financial Review

KCRC is a well-managed and long-established corporation. It is charged with two main duties: to provide high quality transportation and related services, and to operate with commercial prudence.

New Accounting Standards

In 2005 a set of new accounting standards, namely, the Hong Kong Financial Reporting Standards (HKFRS), came into effect replacing the Hong Kong Statements of Standard Accounting Practice (HK-SSAP). A detailed account of the implications resulting from the adoption of the new standards has been provided in note 3 of the Notes to the Financial Statements. The major implications to the Corporation as a result of adopting the new accounting standards are as follows:

(a) adoption of Hong Kong Accounting Standards (HKAS) 32 and 39 requires the recognition of the fair value of derivatives and hedged borrowings in the Balance Sheet and that any changes in their fair value be charged to the Income Statement. In 2005, the Corporation has recognised an unrealised accounting profit of HK$400 million relating to the fair value change of the Corporation's derivatives and hedged borrowings;

(b) adoption of HKAS 40 requires that any changes in fair value of investment properties be charged to the Income Statement. In 2005, the Corporation has recognised an unrealised accounting profit of HK$171 million on the revaluation of the Corporation's investment properties;

(c) adoption of HKAS 16 requires that the Corporation's permanent way be depreciated and that rail replacement costs be capitalised and depreciated. In 2005, this has resulted in an increase in the Corporation's depreciation charge of HK$121 million and a decrease of HK$20 million in operating expenses; and

(d) adoption of Hong Kong Interpretation 4 requires all the fixed assets situated on leasehold land to be depreciated over a period not exceeding the lease term of the leasehold land. In 2005, this has resulted an increase in the Corporation's depreciation charge for tunnels, roads and bridges of HK$178 million.

In compliance with the new accounting standards, 2004 comparative figures have also been re-stated where necessary.

It should be emphasised that all of these changes were made necessary by the adoption of the new HKFRS. These changes do not affect the Corporation's cash flows, nor do they change its underlying business performance.

Profit and Loss

Transport revenue increased by 7.7% to HK$4,612 million, compared with HK$4,281 million in 2004 mainly because of the continued recovery of the local economy, the build up of patronage for West Rail and the full year operation of the Tsim Sha Tsui Extension and Ma On Shan Rail.

Commercial revenue for 2005 from the leasing of shopping centres and office space, estate management, telecommunications, advertising, station kiosks and shops increased by 10.9% to HK$771 million from HK$695 million in 2004, mainly as a result of the opening of new station shops at East Tsim Sha Tsui and Ma On Shan Rail stations during the new extensions' first year of operations.

Operating costs before depreciation for 2005 increased by 7.9% to HK$3,145 million from HK$2,916 million in 2004, mainly because of the full year operation of the Tsim Sha Tsui Extension and Ma On Shan Rail. Staff costs increased by 4% to HK$1,521 million from HK$1,462 million in 2004, energy costs rose by 8.6% to HK$495 million from HK$456 million in 2004, maintenance costs grew by 29.5% to HK$479 million from HK$370 million in 2004, and other expenses increased by 3.5% to HK$650 million from HK$628 million in 2004.

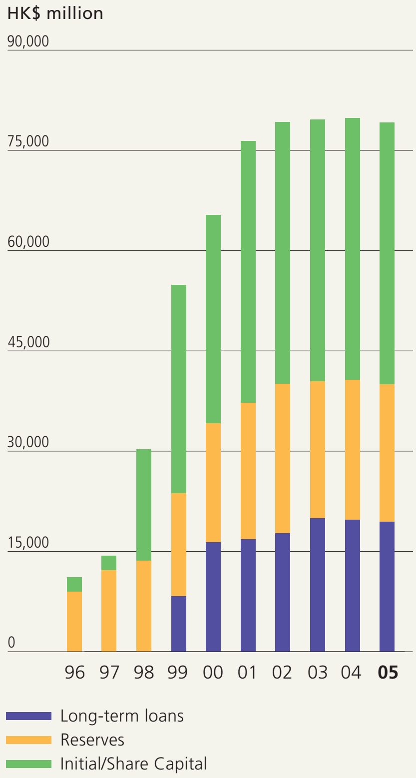
Operating profit before depreciation, interest and finance expenses/(income) and before tax increased by 8.6% to HK$2,238 million in 2005, compared with HK$2,060 million in 2004.

The operating margin before depreciation and net interest and finance expenses/(income) increased from 41.4% in 2004 to 41.6% in 2005.

Depreciation increased by 36.4% to HK$2,140 million from HK$1,569 million in 2004 mainly because of the full year operation of the Tsim Sha Tsui Extension and Ma On Shan Rail and the increased depreciation for tunnels, roads, bridges and permanent way resulting from the adoption of new accounting standards.

Net interest and finance expenses increased from HK$41 million in 2004 to HK$298 million in 2005 mainly because of the full year interest charges related to the Tsim Sha Tsui Extension and Ma On Shan Rail upon their commissioning in late 2004.

Capital Structure



Financial Review

As a result, a loss after depreciation, interest and finance expenses/(income) but before tax of HK$200 million was recorded in 2005, compared with a profit of HK$450 million in 2004.

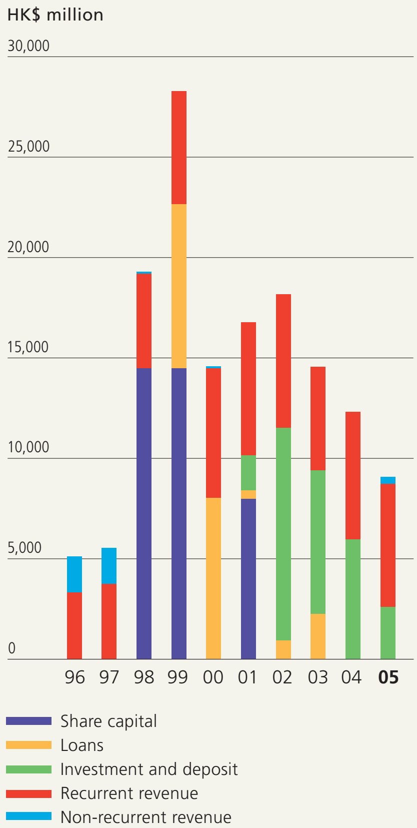
The unrealised accounting profits resulting from the changes in fair value of investment properties, financial instruments and the hedged portion of interest bearing borrowings were HK$571 million in 2005. In 2004, HK$148 million unrealised accounting profit from valuation gain of investment properties was recorded.

A share of profit of an associate of HK$15 million was recognised in the year, the same amount recognised in 2004.

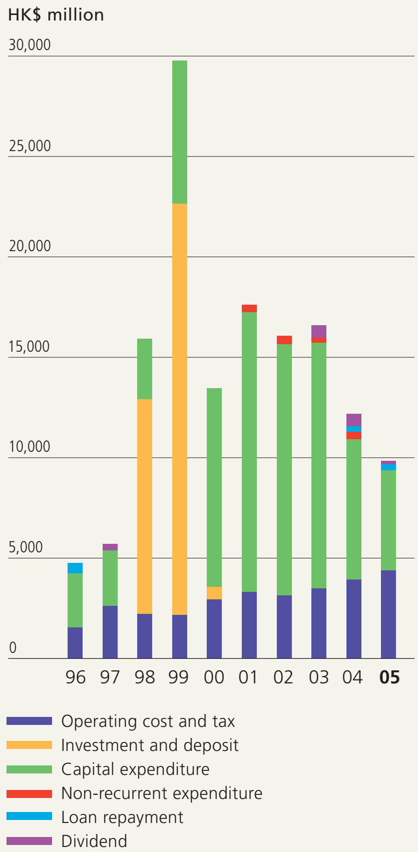
Deferred tax in the amount of HK$69 million was recognised in 2005, compared with HK$100 million in 2004.

Net profit after tax was HK$317 million, a 38.2% reduction compared with HK$513 million in the previous year.

Cash Inflow



Cash Outflow



Capital Expenditure

Capital expenditure decreased by 57.5% from HK$9,025 million in 2004 to HK$3,835 million in 2005 mainly because of the completion of the Tsim Sha Tsui Extension and Ma On Shan Rail, and outstanding works of West Rail in 2004. The capital expenditure of 2005 was mainly for the construction of the Kowloon Southern Link and the Lok Ma Chau Spur Line, investments to prepare for the replacement of aged assets, and safety and environmental improvements.

Cash Flow

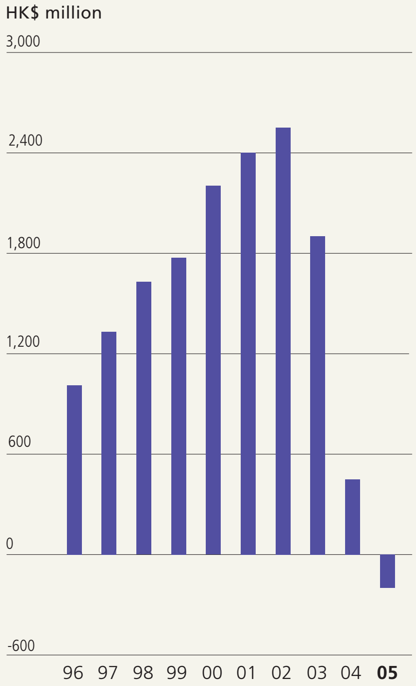
The net cash inflow before financing decreased from HK$2,282 million in 2004 to HK$1,124 million in 2005, mainly due to lower receipts from the redemption and disposal of investments, partly offset by lower capital expenditure after the completion of the Tsim Sha Tsui Extension and Ma On Shan Rail. After including interest and dividend payments and cash flows of other financing activities, there was a net cash outflow of HK$752 million for the year compared to a net cash inflow of HK$114 million for 2004.

Transport

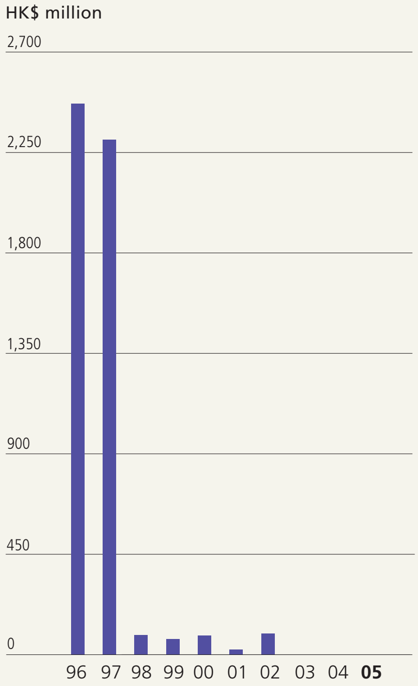
East Rail revenue increased 7.5% from HK$3,415 million in 2004 to HK$3,670 million in the year mainly due to increased patronage resulting from the full year operation of the Tsim Sha Tsui Extension and Ma On Shan Rail.

West Rail and Light Rail revenue increased 11.5% from HK$798 million in 2004 to HK$890 million in the year mainly because of the significant increase in patronage resulting from the continuation of various measures to improve

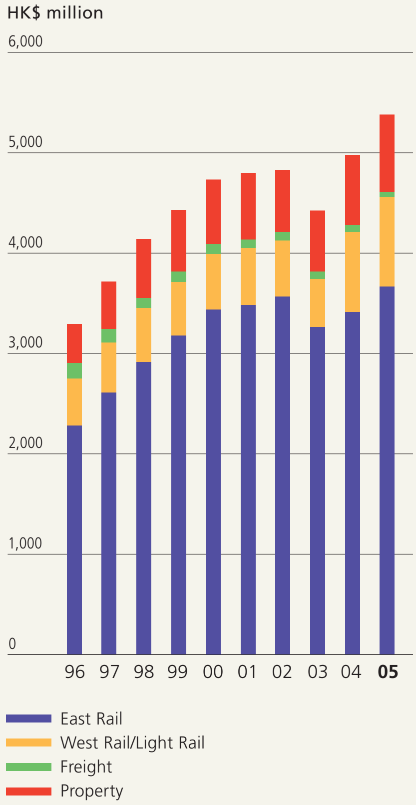
Profit/(Loss) from Operating Businesses (before unrealised accounting profit and tax)



Profit on Property Development (before tax)

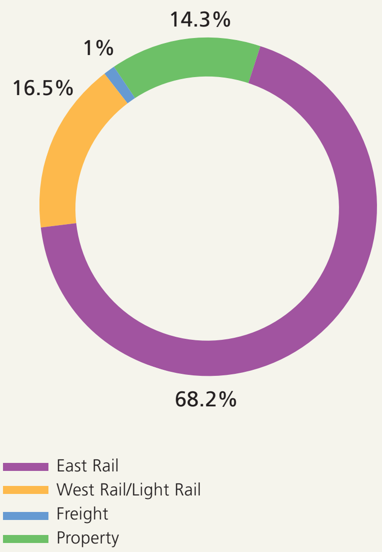


Recurrent Revenue

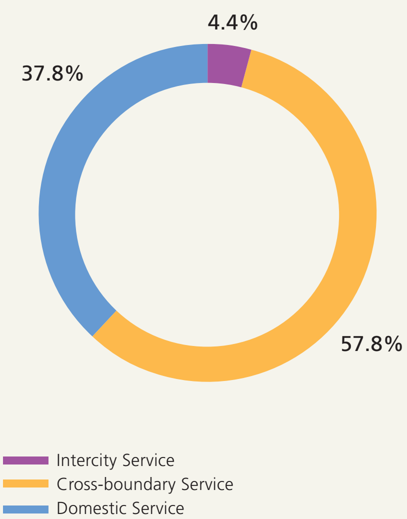


Financial Review

Total Share of Recurrent Revenue



Share of East Rail Recurrent Revenue



accessibility and the introduction of promotional offers.

Freight revenue decreased by 23.5% to HK$52 million in 2005 from HK$68 million in 2004, mainly due to decreases in rail freight traffic and the winding down of the freight forwarding business.

As a result, transport revenue, including fare and non-fare revenue, increased by 7.7% to HK$4,612 million, compared with HK$4,281 million in 2004. Operating costs before depreciation increased by 8% to HK$2,725 million from HK$2,523 million in 2004, mainly due to the full year operation of the Tsim Sha Tsui Extension and Ma On Shan Rail. Profit generated from the Corporation's transport business before depreciation, increased by 7.3% to HK$1,887 million from HK$1,758 million in 2004. However, depreciation increased by 37.7% to HK$2,091 million from HK$1,519 million in 2004, mainly as a result of the new accounting standards in 2005 regarding the depreciation of tunnels, roads, bridges and permanent way, and the full year operation of the Tsim Sha Tsui Extension and Ma On Shan Rail. As a result, a loss before sharing of corporate overheads of HK$204 million was recorded for transport, compared with a profit of HK$239 million in 2004.

Capital expenditure was HK$1,165 million, compared with HK$6,678 million in 2004. The decrease was mainly due to completion of the Tsim Sha Tsui Extension and Ma On Shan Rail, and outstanding works of West Rail in 2004.

Property

Commercial revenue increased to HK$771 million, up 10.9% from HK$695 million in 2004, mainly because of the full year opening of new station shops at East Tsim Sha Tsui Station and along Ma On Shan Rail. Total operating costs before depreciation increased by 17.1% to HK$192 million from HK$164 million in 2004, mainly due to the disposal of assets resulting from the renovation of Ocean Walk, formerly known as Pierhead Plaza. Profit generated from the Corporation's property related business before depreciation increased by 9% to HK$579 million from HK$531 million in 2004. Depreciation increased by 3.6% to HK$29 million from HK$28 million in 2004. Unrealised accounting profit resulting from the change in valuation of investment properties increased by 15.5% to HK$171 million from HK$148 million in 2004. As a result, property related profit before sharing of corporate overhead was HK$721 million, an increase of 10.8% from HK$651 million in 2004.

Capital expenditure was HK$127 million, compared with HK$61 million in 2004. The increase was mainly due to the renovation of Ocean Walk.

Corporate Governance Report

Corporate Governance

The Corporation being a statutory Corporation established in Hong Kong by the Kowloon-Canton Railway Corporation Ordinance (Chapter 372 of the Laws of Hong Kong) (the KCRC Ordinance) is not bound by the Hong Kong Stock Exchange Listing Rules. It does, however, as a matter of policy comply to the extent that it is able to do so, with such Rules, The Hong Kong Stock Exchange Code on Corporate Governance (the Code) and all applicable Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants, accounting principles generally accepted in Hong Kong and the disclosure requirements of the Hong Kong Companies Ordinance. The Corporation has gone to considerable lengths to ensure that it not merely complies with, but wherever possible, goes beyond established best practice in the field of corporate governance. The Corporation has adopted core values and standards which set out the behaviour expected of staff in their dealings with its sole shareholder, the Government of the Hong Kong Special Administrative Region, as well as those it serves, colleagues, suppliers and other stakeholders. One of the core values underpinning the Corporation's Mission and Vision Statement, which is stated in the Annual Report on page 2, is a belief shared by every member of staff that the highest standards of integrity which are essential in the Corporation's business must be maintained.

The Managing Board

The Corporation and its wholly or majority owned subsidiary companies are controlled through its Managing Board (the Board). The Board's main roles are to ensure that the Corporation complies in every respect with the provisions of the Ordinance to create value for its sole shareholder, to provide leadership to the Corporation, to approve the Corporation's strategic objectives and to ensure that the necessary financial and other resources are made available to Management to enable them to meet those objectives. The Board, which meets at least 11 times a year, has a schedule of matters reserved for its approval.

The specific responsibilities reserved for the Board include but are not limited to:

(a) Rules for conduct of the Corporation's business
(b) By-laws
(c) Three Year Business Plans, including revenue, expenses and capital budgets for the ensuing year, annual manpower plan and pay review
(d) Annual budget
(e) Annual report and audited financial statements
(f) Recommendations with respect to dividend payments
(g) Major business strategies
(h) Passenger fares and freight charges
(i) Capital projects, and variations to capital projects, in excess of HK$50 million
(j) Of all major contracts –
  (1) All contracts, and variations to all contracts, in excess of HK$50 million
  (2) All non-lowest conforming expenditure and all non-highest conforming revenue contracts, and variations to such contracts, in excess of HK$20 million
  (3) All consultancy contracts, and variations to consultancy contracts, in excess of HK$10 million
(k) Substantive appointments of the Chief Executive Officer (CEO), Senior Directors, Directors, Deputy Directors, and General Managers who directly report to the CEO
(l) Borrowings
(m) Purchase and sale of all real estate
(n) Formation, acquisition and disposal of companies
(o) Write off of fixed assets, the original cost of each of which exceeded HK$50 million, and the write off of capitalised expenses exceeding HK$10 million each

In addition to the above Management must report to the Board monthly on significant developments, together with the operating and financial results, information on use of the Corporate Seal, letting of major contracts, accidents, service disruptions, public complaints and any other matters which may be required by the Board from time to time.

Corporate Governance Report

The Board has delegated all other authorities to carry out the Corporation's activities to the Chief Executive Officer.

The Role of the Chairman and Chief Executive Officer

The Kowloon-Canton Railway Corporation Ordinance provides for the separation of the posts of the Chairman and Chief Executive Officer. The division of responsibilities between the Chairman of the Board and the Chief Executive Officer is clearly defined and has been approved by the Board.

The Chairman, who is a non-executive Member, leads the Board in the determination of its strategy and in the achievement of its objectives. The Chairman is responsible for the conduct of the business of the Board, ensuring its effectiveness and setting its agenda. The Chairman is not involved in the day-to-day business of the Corporation. The Chairman facilitates the effective contribution of the non-executive Members of the Board and constructive relations between executive management and such Members, ensuring that Members receive accurate, timely and clear information, as well as ensuring effective communication with the Corporation's sole shareholder.

The Chief Executive Officer has direct charge of the Corporation on a day-to-day basis and is accountable to the Board for the Corporation's financial and operational performance.

Members and Members' Independence

The Board currently comprises the Chairman, the Chief Executive Officer, two ex-officio Members and six independent non-executive Members. The Chairman and all Members with the exception of the Chief Executive Officer, who is appointed by the Corporation, are appointed by the Chief Executive of the Hong Kong Special Administrative Region. The names of the Members together with their biographical details are set out on pages 8 and 9. All Members served throughout the year ended 31 December 2005. The two ex-officio Members are the Secretary for the Environment, Transport and Works and the Secretary for Financial Services and the Treasury. The Board's independent non-executive Members constructively challenge and help develop proposals on strategy and bring strong, independent judgement, knowledge and experience to the Board's deliberations. All Members are of sufficient calibre and number that their views carry significant weight in the Board's decision-making process.

Members have, if required, access to independent professional advice at the Corporation's expense, in order for them to carry out their responsibilities. Details of the Chairman's professional commitments are included in the Chairman's biography. The Chairman does perform a number of pro-bono roles but these are not such as to interfere with the performance of the Chairman's duties to the Corporation which are based around a commitment of approximately 80 days per annum.

The Board considers all its non-executive Members to be independent in character and judgement. No non-executive Member:

(a) has been an employee of the Corporation within the last five years;
(b) has, or has had within the last three years, a material business relationship with the Corporation;
(c) receives remuneration other than an annual honorarium which is fixed by the Financial Secretary of the Government of the Hong Kong Special Administrative Region;
(d) has close family ties with any of the Corporation's advisors, Members or senior management;
(e) holds cross-directorships or has significant links with other Members through involvement in other companies or bodies; and
(f) has served on the Board for more than nine years.

Professional Development

On appointment, each Member is given an induction briefing, during which they receive information about the Corporation, the role of the Board and the matters reserved for its decision, the terms of reference and membership of the Board and its committees, and the powers delegated to those committees, the Corporation's corporate governance practices and procedures, including the powers reserved for the Corporation's most senior executives, and the latest financial information about the Corporation. This is supplemented by visits to key locations and meetings with key senior executives. Throughout their period in office Members are continually updated on the Corporation's business, the competitive and regulatory environments in which it operates, corporate social responsibility matters and other changes affecting the Corporation and the industry it operates in as a whole, by written briefing papers and meetings with senior executives. Members are also advised, on appointment, of their legal and other duties and obligations as a Member of the Board, by the Company Secretary. They are regularly reminded of these duties and updated on changes to the legal and governance requirements which impact on the Corporation and themselves as Members of the Board.

The Company Secretary

The Company Secretary is responsible for advising the Board, through the Chairman, on all governance matters. Members have access to the advice and services of the Company Secretary. The Corporation's schedule of matters reserved for the Board for decision provide that the appointment of the Company Secretary is a matter for the full Board.

Information

Regular reports and papers are circulated to Members in a timely manner in preparation for Board and Committee meetings. These papers are supplemented by information specifically requested by Members from time to time. All Members receive monthly management accounts and regular management reports, and information pertaining to the operation and safety of the railway, which enable them to scrutinise the Corporation's and management's performance against agreed objectives.

Relations with the Sole Shareholder

To fulfil the Chairman's obligations under the Ordinance and the Code, the Chairman gives feedback to the Board on issues raised with him by the Corporation's sole shareholder.

The Corporation maintains a corporate website, www.kcrc.com containing a wide range of information of interest to all stakeholders.

Internal Control

The Board is ultimately responsible for the Corporation's system of internal control. It ensures, through the Audit Committee, that appropriate policies on internal control are in place and through this Committee seeks assurance that enables it to satisfy itself that the system is functioning effectively, and that the system of internal control is effective in managing risks in the manner which they are approved.

Members have continued to review the effectiveness of the Corporation's system of internal controls through the Audit Committee, including operational and compliance controls, risk management and the Corporation's internal control arrangements. These reviews have included an assessment of internal control and, in particular, internal financial control, by the internal audit function, management assurance of the maintenance of control and reports from the external auditor on matters identified during the course of statutory audit work. A key part of these reviews is an annual certificate of assurance process by which responsible managers confirm the adequacy of their systems of internal controls, their compliance with corporate policy, local laws and regulations and report any control weaknesses identified in the past year.

The Corporation views the careful management of risk as a key management activity. Managing business risk to deliver opportunities is a key element of all activities. This is done using a simple and flexible framework that provides a consistent and sustained way of implementing the Corporation's values. These business risks, which may be strategic, operational, or reputation-related are made known to Members. The business context determines in each situation the level of acceptable risk and controls.

Corporate Governance Report

Board and Committee Meetings

The number of Board and Committee Meetings held and attended (in parenthesis) by each Member during the year are listed in the table below.

The Board appoints to each Committee one or more Expert Members, who have acknowledged expertise in the matters covered by those committees. Expert Members provide constructive input into matters considered and decisions made by the Committees. Whilst they play an important role in the deliberations of each Committee, Expert Members, not being Members of the Board, do not form part of a quorum or have voting rights.

	Board Meetings	Audit Committee	Property Committee	Capital Projects Committee	Strategic Human Resource Committee	Finance Committee
Chairman Mr. Michael Tien Non-Executive Member	12 (12)				3 (3)	
Chief Executive Officer (Acting) Mr. Samuel M H Lai Executive Member	12 (12)		10 (10)	12 (11)		2 (2)
Ex-Officio Member Mr. Frederick Ma Si-hang	12 (3)[1]		10 (0)[7]	12 (0)[3]	3 (0)[5]	2 (0)[8]
Ex-Officio Member Dr. Sarah Liao Sau-tung	12 (4)[2]			12 (0)[4]	3 (0)[6]	
Non-Executive Member Mr. Vincent Lo Wing-sang	12 (10)		10 (10)			
Non-Executive Member Mr. Wan Man-yee	12 (12)	5 (5)	10 (5)	12 (12)		
Non-Executive Member Mr. Patrick B Paul	12 (10)	5 (5)			3 (2)	
Non-Executive Member Professor Richard Wong Yue-chim	12 (9)		10 (1)	12 (3)		2 (2)
Non-Executive Member The Honourable Abraham Shek Lai-him	12 (10)	5 (4)		12 (4)	3 (2)	
Non-Executive Member Mr. Ng Leung-sing	12 (12)		10 (5)	12 (6)		2 (1)

[1] *Alternates attended 9 meetings*
[2] *Alternates attended 8 meetings*
[3] *Alternates attended 11 meetings*
[4] *Alternates attended 11 meetings*
[5] *Alternates attended 3 meetings*
[6] *Alternates attended 3 meetings*
[7] *Alternates attended 10 meetings*
[8] *Alternates attended 2 meetings*

The number of Board and Committee Meetings held and attended (in parenthesis) by each Expert Member during the year are listed in the table below.

Audit Committee

During the year, the Audit Committee comprised Mr. Patrick Paul (Chairman), Mr. Wan Man-yee and The Hon. Abraham Shek. All members of the Committee are independent non-executive Members. The Audit Committee met 5 times during the year. The Committee has at least one member possessing "recent and relevant experience", namely, Mr. Patrick Paul who is a chartered accountant and was formerly Chairman of PricewaterhouseCoopers (HK). It can be seen from the Members' biographical details, appearing on pages 8 and 9 that the other members of the Committee bring to it a wide range of experience from positions at the highest level in Hong Kong.

Under its terms of reference, the Audit Committee monitors the integrity of the financial statements and any formal announcements relating to the Corporation's performance. The Committee is responsible for monitoring the effectiveness of the external audit process and making recommendations to the Board in relation to the appointment, re-appointment and remuneration of the external auditor. It is responsible for ensuring that an appropriate relationship between the Corporation and the external auditor is maintained, including reviewing non-audit services and fees. It also reviews annually the Corporation's systems of internal control and the processes for monitoring and evaluating the risks facing the Corporation. The Committee reviews the effectiveness of the internal audit function and is responsible for recommending to the Managing Board, upon the recommendation of the Chief Executive Officer, the appointment and termination of the Head of that function. The Committee has undertaken to review its terms of reference at least once every three years and its effectiveness, and if appropriate, will recommend to the Board any changes required as a result of the review.

The Committee meets with Executive Directors and Management, as well as privately with both the external and internal auditors. The Committee's terms of

Expert Member[1]	Property Committee	Capital Projects Committee	Strategic Human Resource Committee	Finance Committee
Mr. Philip Nunn	10 (9)			
Mr. Alfred Li Hung-kwan				2 (2)
Mr. Greg Wong Chak-yan		12 (10)		
Mr. Hung Wing-tat		12 (11)		
Mr. Wan Man-lung		12 (11)		
Ms. Jennifer Lee-shoy		12 (9)		
Mr. Ernest Kwok Siu-keung		12 (7)		
Ms. Paula Ko Wong Chau-mui			3 (2)	
Ms. Anita To Yu Ming-chi			3 (3)	

[1] *Details of Expert Members are to be found in the Report of the Members of the Managing Board on page 89.*

reference are available from the Company Secretary and are displayed on the Corporation's website, www.kcrc.com. In 2005 the Audit Committee discharged its responsibilities by:

(a) reviewing the Corporation's draft financial statements prior to Board approval;
(b) reviewing the external auditor's reports thereon;
(c) reviewing the appropriateness of the Corporation's accounting policies;
(d) reviewing at various times the potential impact of the generally accepted accounting principles in Hong Kong and US on the Corporation's financial statements;
(e) reviewing, recommending or pre-approving audit fees or non-audit fees;
(f) reviewing the external auditor's plan for the audit of the Corporation's financial statements, which includes key areas of focus; and
(g) approving the annual internal audit plan and reviewing reports on the adequacy and effectiveness of systems of internal control, financial reporting and risk management.

The Audit Committee has taken on responsibility for monitoring the Corporation's whistle blowing procedures, which ensure that appropriate arrangements are in place for employees to be able to raise matters of possible impropriety in confidence, with suitable subsequent follow-up action.

Auditors' Independence and Objectivity

The Audit Committee monitors regularly and closely the non-audit services being provided to the Corporation and its subsidiary companies by its external auditor, who is appointed by the Chief Executive of the Hong Kong Special Administrative Region, to ensure that the provision of such services does not impair their independence or objectivity. If and when appropriate the Committee will engage the services of alternative, appropriately qualified accounting firms to undertake non-audit services. When considering any non-audit work to be undertaken by the external auditor, the Committee is mindful of the need to be satisfied that the external auditor should not audit its own work, make management decisions for the Corporation or its subsidiaries, have a mutuality of financial interest with the Corporation or its subsidiaries or be put in the role of advocate for the Corporation or its subsidiaries. The Committee also takes into consideration relevant professional and regulatory requirements so that these are not impaired by the provision of permissible non-audit services. Prior approval by the Audit Committee is required for any services provided by the external auditors. Any activities that may be perceived to be in conflict with the role of the external auditor must be submitted to the Committee for its consideration and approval prior to engagement. Details of the amounts paid to the external auditors during the year for audit and other services are set out in the notes to the financial statements on page 123.

Property Committee

The Property Committee oversees all property development matters and considers any proposals to generate additional revenue from the land and property held by the Corporation, and through the Corporation, the purchase of commercial properties constructed in conjunction with its new railway projects. Mr. Vincent Lo Wing-sang chairs this Committee.

The Property Committee consists of at least three Members of the Board, with its quorum being at least half the Committee Members.

The Board may appoint Expert Members to the Property Committee to provide advice, but they will not count towards the quorum of the Committee.

The terms of reference of the Property Committee are to keep under review and to advise the Board on the strategies for and progress on:

(a) property development for sale or investment;
(b) the leasing of the Corporation's property portfolio; and

(c) optimising the potential of the Corporation's land and property portfolio to generate additional commercial income for the Corporation.

In addition, it is specifically required:

(a) in respect of property development –

1. to review periodically and to advise the Board on the Corporation's overall property development programmes;
2. to review all proposed new property development projects, after technical and financial viability studies have been carried out, and prior to their submission by Management to the Town Planning Board;
3. to approve the evaluation criteria for short listing property developers;
4. to approve the short list of property developers;
5. to approve the evaluation criteria for assessing tenders from property developers;
6. to endorse the final selection of developers and to recommend them to the Board for approval;
7. to endorse the proposed Heads of Agreement for specific property development projects, and to recommend them to the Board for approval;
8. to keep under review the Corporation's standard Joint Venture Agreement for property development projects, to endorse any proposed changes that are necessary in respect of any specific property development project and to recommend such changes to the Board for approval;

(b) in respect of investment in leasing and disposal of property –

9. to examine any proposals for the Corporation to invest in commercial properties and to make appropriate recommendations to the Board;
10. to examine any proposals for leasing of Corporation property where the total revenue for the Corporation from the lease is estimated to exceed HK$20 million and to make appropriate recommendations to the Board;
11. to examine any proposals for disposing of property and to make appropriate recommendations to the Board; and

(c) in respect of generating additional commercial income –

12. to examine any proposals for generating additional revenue in excess of HK$20 million from the land or property held by the Corporation and to make appropriate recommendations to the Board.

The Strategic Human Resource Committee

This Committee reviews and makes recommendations to the Board with respect to the appointments and terminations of appointment and remuneration of the Chief Executive Officer, Executive Directors who are not Members of the Managing Board and those Senior Executives who report directly to the Chief Executive Officer. It also recommends to the Board the appropriate levels of remuneration for all staff. Mr. Michael Tien chairs this Committee.

The Strategic Human Resource Committee consists of at least three non-executive Members of the Board, with the quorum being at least half of the Committee Members.

The Board may appoint Expert Members to the Strategic Human Resource Committee to provide advice, but they will not count towards the quorum of the Committee.

Corporate Governance Report

The Strategic Human Resource Committee is responsible to the Board and may meet as frequently as it decides. Its terms of reference are as follows:

(a) to review and recommend to the Board all proposals for creation and deletion of posts in the ranks of Senior Director, Director and Deputy Director;
(b) to review the outcome of all acting appointments made with a view to substantive promotion to the ranks of Senior Director, Director and Deputy Director, and to recommend to the Board all appointments, promotions, and contract renewals together with their remuneration, of all staff to fill all posts in these ranks;
(c) to recommend to the Board all appointments, promotions, and contract renewals together with their remuneration, of all staff to fill those Senior Executive posts which report directly to the Chief Executive Officer, namely, Company Secretary and General Counsel, General Manager – Corporate Affairs and General Manager – Internal Audit;
(d) to review and recommend to the Board terminations of contracts and summary dismissals, together with their terms and conditions, of all staff in the ranks of Senior Director, Director, Deputy Director and Senior Executive;
(e) to review annually the pay and conditions of the Chief Executive Officer and to recommend to the Board, for endorsement, any proposed adjustment, prior to this being put, via the Secretary for the Environment, Transport and Works, to the Chief Executive of the Hong Kong Special Administrative Region for approval;
(f) to review annually the remuneration of all staff in the ranks of Senior Director, Director, Deputy Director and Senior Executive, and to recommend to the Board their respective adjustments in remuneration;
(g) to review annually the market pay trend data and to recommend to the Board the adjustments in remuneration to be applied by Management to all staff in the Executive, Management and Non-management ranks; and
(h) to advise the Board on any proposal to make a major change to existing terms and conditions of service for employees of the Corporation, or to introduce any major new term and condition of service.

Capital Projects Committee

This Committee keeps under review and makes recommendations to the Board on subjects relating to all major capital projects undertaken by the Corporation, excluding property development projects. Mr. Wan Man-yee chairs the Capital Projects Committee.

The Capital Projects Committee consists of at least three Members of the Board, with its quorum being at least half the Board Members.

The Board may appoint Expert Members to the Capital Projects Committee to provide advice, but they will not count towards the quorum of the Committee.

The terms of reference of the Capital Projects Committee are to keep under review and to make recommendations to the Board on the following subjects in respect of capital projects associated with West Rail, East Rail, the East Rail Extensions and other new railway projects:

(a) Proposals for defining scope, engineering feasibility, cost and financial viability of the projects at the conceptual stage;
(b) Project Agreements and other contractual arrangements with the Government in respect of capital projects;
(c) The contract strategies for the projects;
(d) The conditions of contract for the projects, including procedures to control project expenditure, major variation orders and claim resolution, and their application by Management; and
(e) The progress of the projects, including proposals for significant changes in their respective scopes, programmes, designs, costs, budgets and

contracts management and any other significant issues.

The Finance Committee

The Finance Committee deals with the investment of surplus funds and financing arrangements generally, and advises the Board on the Corporation's strategies for the financing of future major capital projects. The Corporation's Treasury Department operates within a set of strategies, policies and guidelines, which are defined by the Board to cover funding, cash investment, and risk management. Professor Richard Wong Yue-chim chairs the Finance Committee.

The Finance Committee consists of at least three Members of the Board, with its quorum being at least half the Board Members.

The Board may appoint Expert Members to the Finance Committee to provide advice, but they will not count towards the quorum of the Committee.

The Finance Committee is required generally to deal with the investment of surplus funds and to advise the Board on the Corporation's strategies for the financing of future major capital projects. Specifically it is required:

Investment of Surplus Funds

1. to apply approved evaluation criteria for shortlisting and selecting companies to act as investment managers or custodians;
2. to evaluate proposals from potential investment managers and custodians and to make recommendations to the Board on appointment of these companies;
3. to determine the amounts of surplus funds to be managed by investment managers and by the Corporate Treasury Department;
4. to develop specific cash investment guidelines;
5. to review and monitor the investment performances of investment managers, custodians and the Corporate Treasury Department;
6. to terminate the appointment of investment managers or custodians, as required;

Financing Strategies

7. to develop financing strategies in respect of major capital projects and ongoing funding requirements and to make recommendations to the Board;
8. subject to the financing strategies developed under (7) above being accepted by the Corporation and the Government, and to their proper reflection in Project Agreements, to ensure that the funding requirements of the Corporation are adequately met; and

Others

9. to perform any other related task that the Board may remit.

Report of the Members of the Managing Board

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

Kowloon-Canton Railway Corporation Ordinance

The Kowloon-Canton Railway Corporation Ordinance (the KCRC Ordinance), enacted in 1982, established the Corporation and empowered it to operate the Kowloon-Canton Railway. Amendments in 1986 and 1998 empowered the Corporation to construct and operate Light Rail and new railways, and enabled the Government to inject equity into the Corporation to fund the construction of such new railways. Inter alia, the KCRC Ordinance contains provisions covering the appointments and roles of the Members of the Managing Board.

An amendment of the KCRC Ordinance in December 2001 provided for the separation of the functions and duties of the Chairman from those of the Chief Executive by creating the office of Chief Executive Officer of the Corporation. The Chief Executive Officer was also appointed as a Member of the Managing Board.

Principal Activities of the Corporation

The principal activities of the Corporation are:

- the operation of a railway system between Kowloon (East Tsim Sha Tsui Station) and Lo Wu, between Tuen Mun and Nam Cheong and between Tai Wai and Wu Kai Sha
- the operation of cross-boundary passenger and freight services in association with Mainland railway authorities
- the operation of the North West New Territories light rail system
- the detailed planning, design and construction of extensions to the current railway system
- the development of associated commercial activities, including the sale of advertising space, the marketing of concessions and property leasing
- the development of property
- the operation of feeder bus services

The principal activities of the subsidiary companies incorporated to facilitate the undertaking of the above activities are set out in Note 18 to the financial statements.

The Managing Board

Members

The Board is the governing body of the Corporation with authority to exercise the duties conferred upon it by the KCRC Ordinance. The Board comprises the Chairman and eight members, all of whom are appointed by the Chief Executive of the Hong Kong Special Administrative Region, and the Chief Executive Officer, who is appointed by the Corporation subject to the prior approval of the Chief Executive of the Hong Kong Special Administrative Region.

During the year under review, Members of the Board who served were Mr. Michael Tien (Chairman), Mr. Samuel M.H. Lai (Chief Executive Officer (Acting), Mr. Vincent Lo Wing-sang, Mr. Frederick Ma Si-hang (the Secretary for Financial Services and the Treasury), Dr. Sarah Liao Sau-tung (the Secretary for the Environment, Transport and Works), Mr. Wan Man-yee, Mr. Patrick B. Paul, Professor Richard Wong Yue-chim, The Honourable Abraham Shek Lai-him and Mr. Ng Leung-sing. Brief biographical details of Board Members are set out on pages 8 and 9.

Alternate Members

Alternate Members in office during 2005 were Mr. Martin McKenzie Glass, Mr. David Lau, Mr. Tommy Yuen and Mr. Lai Nin, Alan (alternates for the Secretary for Financial Services and the Treasury), and Mr. Law Chi-kong, Joshua, Miss Cathy Chu Man-ling, Mr. Chow Tat-ming, Thomas, Mr. Patrick Ho, Mr. Henry Chan and Mr. Raymond Ho (alternates for the Secretary for the Environment, Transport and Works).

The Board meets regularly each month save for August, the summer recess, and on an ad hoc basis when appropriate. It is responsible, inter alia, for overall corporate strategy, acquisition and divestment policy, approval of the Corporation's annual budget, major financing arrangements, passenger fares and freight charges, and for ensuring that sound administrative systems and procedures are in place. It also reviews monthly the Corporation's operating results, safety record, and the progress made towards annual targets. The Board has delegated to the Chief Executive Officer the authority for the management of day-to-day operations.

Committees

Committees have been formed to oversee specific aspects of the Corporation's operations and function and to make appropriate recommendations to the Managing Board for decision. These committees, with the exception of the Audit Committee, are served by a number of Expert Members, each being appointed for a term of one year. These experts serve in an advisory capacity. Appointed to the Capital Projects Committee are Dr. Greg Wong Chak-yan, a consulting civil engineer; Mr. Wan Man-lung, Principal Government Engineer, Rail Development; Dr. Hung Wing-tat, an Associate Professor of Civil Engineering of the Hong Kong Polytechnic University; Miss Jennifer Lee-shoy, a lawyer specialising in Construction Law; and Mr. Ernest Kwok Shiu-keung, a lawyer and civil engineer (resigned in December 2005). Appointments to the Strategic Human Resource Committee included Mrs Paula Ko Wong Chau-mui, a senior human resource executive of a major bank (resigned in December 2005); and Mrs Anita To Yu Ming-chi, a general manager of a multinational company. Appointed to the Property Committee, is Mr. Philip Nunn, a lawyer with expertise in construction, arbitration and property development, and appointed to the Finance Committee, Mr. Alfred Li Hung-kwan, a retired Chartered Accountant and company executive director. With the exception of those who resigned in 2005, all Expert Members had their appointments renewed in December 2005 for a further one year.

The appointment of these Expert Members, who are not Members of the Managing Board, is intended to strengthen the role of the various committees in the execution of their various roles and as advisors to the Managing Board. The various committees and their functions are described on pages 83 to 87.

Long-term Planning, Business Planning and Financial Management Framework

Business plans, incorporating triennial forecasts of income and

Report of the Members of the Managing Board

expenditure, are prepared each year for submission to the Managing Board. The first year of the Business Plan forms the basis for formulating the Budget for that year.

There are defined procedures and regular quality reviews of the operation of the Corporation's computerised systems to ensure the accuracy and completeness of financial records and the efficiency of data processing. There are defined procedures for the appraisal, review and approval of all major capital projects, and all major expenditure and revenue contracts. All capital projects over HK$50 million, all contracts over HK$50 million and all consultancy services over HK$10 million require the approval of the Managing Board. Operating and financial reports, comparing results against their respective budgets and providing updates on significant events, are put to and conducted by the Managing Board on a monthly basis.

Corporate Governance

The Managing Board maintains high standards of corporate governance. It supports the principles of good corporate governance contained in the Cadbury Committee's Code of Best Practice and requires that these be followed by the Corporation to the extent that they are applicable to it, given that it is a statutory and unlisted body. Although not required to do so, the Corporation has complied throughout the year with the New Code of Corporate Governance as set out by The Stock Exchange of Hong Kong Limited in Appendix 14 to the Listing Rules to the extent that they are applicable to the Corporation. It is the Corporation's policy to be responsive to key stakeholders, the Government and its customers and to ensure that its business transactions are transparent.

The Corporation has since 2003 adopted a code of ethics that complies with Section 406 of The Sarbanes-Oxley Act of 2002 and Items 406 and 601 of the Securities and Exchange Commission Regulation S-K. The code applies to all Senior Financial Officers of the Corporation, which comprise its Chief Executive Officer, Director-Finance, General Manager-Financial Control and General Manager-Corporate Treasury, as well as to any other person performing similar functions. Details relating to Corporate Governance are to be found on pages 79 to 87.

Memberships of the Managing Board, its Committees and Executive Directors who are not Members of the Managing Board

Details of the Members of the Managing Board, members of Committees and Executive Directors who are not Members of the Managing Board, for the year are listed on pages 8 to 11.

Interests in Contracts of Members of the Managing Board, Expert Members of Committees and the Executive Directors who are not Members of the Managing Board

No contracts of significance to which the Corporation or any of its subsidiaries was a party and in which a Member of the Managing Board, or Expert Members of Committees and Executive Directors who are not Members of the Managing Board, had a material interest subsisted at the end of the year or at any time during the year.

At no time during the year was the Corporation or any of its subsidiaries a party to any arrangements to enable Members of the Managing Board, or Expert Members of Committees and Executive Directors who are not Members of the Managing Board, to acquire benefits by means of the acquisition of shares in or debt securities of the Corporation or subsidiaries of the Corporation.

Customers and Suppliers

Turnover attributable to the five largest customers of the Group (which comprises the Corporation and its subsidiaries) accounted for less than 30% of the total turnover of the Group for the year. Purchases attributable to the five largest suppliers of the Group accounted for less than 30% of the value of the Group's total purchases for the year.

Financial Statements
The results of the Group for the year ended 31 December 2005 and the state of affairs of the Corporation and of the Group at that date are set out in the financial statements on pages 94 to 170.

Fixed Assets
Movements in fixed assets during the year are set out in Note 14 to the financial statements.

Share Capital
Details of the Corporation's share capital are set out in Note 31 to the financial statements. Any further contributions of capital will be determined by the Government in consultation with the Corporation.

Dividend
Details of the Corporation's proposed dividend to the Government are set out in Note 12 to the financial statements.

Retirement Benefit Scheme
Details of the Corporation's retirement benefit scheme are set out in Note 37 to the financial statements.

Capitalised Interest and Finance Income/Expenses
Details of the Corporation's capitalised interest and finance income/expenses are set out in Note 8 to the financial statements.

Interest-bearing Borrowings
Details of the Corporation's interest-bearing borrowings are set out in Note 29 to the financial statements.

Turnover, Financial Results and Financial Position
Details of the Corporation's turnover, financial results and financial position are set out in the financial statements, the Chief Executive Officer's Statement, Financial Review and the Ten-year Statistics of the annual report.

Donations
Donations made during the year amounted to HK$260,000, HK$200,000 of which was revenue paid to charities from the Ma On Shan Rail and Tsim Sha Tsui Extension opening charity rides.

Going Concern
The financial statements on pages 94 to 170 have been prepared on a going concern basis. The Board has approved the Corporation's budget for 2006 and is satisfied that the Corporation can operate in a viable manner for the foreseeable future.

Responsibility for the Financial Statements
The Kowloon-Canton Railway Corporation Ordinance requires the Corporation to produce financial statements. In doing so, the Corporation complies with all applicable Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants, accounting principles generally accepted in Hong Kong, the disclosure requirements of the Hong Kong Companies Ordinance and the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, and produces financial statements that give a true and fair view of the Corporation's financial results and position for the financial year to which they relate.

Auditors
In accordance with section 14B (4) of the Kowloon-Canton Railway Corporation Ordinance, KPMG were appointed as auditors by the Chief Executive of the Hong Kong Special Administrative Region.

By order of the Managing Board
David Fleming
Company Secretary
27 February 2006

Contents

Auditors' Report

Auditors' Report to the Members of the Managing Board of the Kowloon-Canton Railway Corporation

We have audited the financial statements on pages 94 to 170 which have been prepared in accordance with accounting principles generally accepted in Hong Kong.

Respective Responsibilities of the Corporation and Auditors

The Kowloon-Canton Railway Corporation Ordinance requires the Corporation to prepare financial statements and the Corporation has resolved to prepare financial statements which give a true and fair view. In preparing financial statements which give a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently, that judgements and estimates are made which are prudent and reasonable and that the reasons for any significant departure from applicable accounting standards are stated.

It is our responsibility to form an independent opinion, based on our audit, on those financial statements and to report our opinion solely to you, as a body, in accordance with section 14B(3) of the Kowloon-Canton Railway Corporation Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

Basis of Opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the Corporation in the preparation of the financial statements, and of whether the accounting policies are appropriate to the Corporation's and the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the financial statements are free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion, the financial statements give a true and fair view of the state of affairs of the Corporation and of the Group as at 31 December 2005 and of the Group's profit and cash flows for the year then ended and have been properly prepared in accordance with the applicable disclosure requirements of the Hong Kong Companies Ordinance.

KPMG
Certified Public Accountants
Hong Kong
27 February 2006

Consolidated Income Statement

for the year ended 31 December 2005 (Expressed in Hong Kong dollars)

	Note	**2005 $ million**	2004 Restated $ million
Turnover	4	**5,383**	4,976
Operating costs before depreciation	5	**3,145**	2,916
Operating profit before depreciation	6	**2,238**	2,060
Depreciation	7	**2,140**	1,569
Operating profit before interest and finance income/expenses		**98**	491
Interest and finance income	8(a)	**525**	444
Interest and finance expenses	8(b)	**(823)**	(485)
Profit/(loss) after depreciation, interest and finance income/expenses		**(200)**	450
Gains on changes in fair value of derivative financial instruments and hedged borrowings	9	**400**	–
Valuation gains on investment properties	14	**171**	148
Share of profit of associate		**15**	15
Profit before taxation		**386**	613
Income tax	10(a)	**(69)**	(100)
Profit for the year wholly attributable to the sole shareholder of the Corporation	11	**317**	513
Dividend payable to the sole shareholder of the Corporation attributable to the year proposed after the balance sheet date	12(a)	**–**	172

The notes on pages 100 to 170 form part of these financial statements.

Consolidated Balance Sheet

at 31 December 2005 (Expressed in Hong Kong dollars)

	Note	**2005** **$ million**	2004 Restated $ million
Assets			
Fixed assets	14		
– Property, plant and equipment		**60,127**	61,029
– Investment properties		**1,171**	1,026
		61,298	62,055
Interest in leasehold land held for own use under operating leases	14	**5,645**	5,691
Construction in progress	15	**10,411**	6,991
Deferred expenditure	16	**1,210**	1,462
Properties under development	17	**1,537**	1,892
Interest in associate	19	**72**	57
Loans to third party	20	**684**	733
Loan to non-controlled subsidiary	21	**3,863**	3,576
Derivative financial assets	33(e)	**129**	–
Investments	22	**449**	4,323
Stores and spares	23	**343**	319
Interest and other receivables	24	**717**	756
Cash and cash equivalents	25	**3,394**	3,531
		89,752	91,386
Liabilities			
Interest and other payables	26	**2,803**	2,929
Accrued charges and provisions for capital projects	27	**3,038**	3,971
Lease payable	28	**684**	717
Derivative financial liabilities	33(e)	**361**	–
Interest-bearing borrowings	29	**19,474**	19,748
Deferred income	30	**541**	708
Deferred tax liabilities	10(d)	**3,198**	3,251
		30,099	31,324
Net Assets		**59,653**	60,062
Capital and Reserves			
Share capital	31	**39,120**	39,120
Reserves	32	**20,533**	20,942
Total equity		**59,653**	60,062

Approved and authorised for issue by the Managing Board on 27 February 2006.

Michael Tien
Samuel Lai
Patrick B Paul
Members of the Managing Board

The notes on pages 100 to 170 form part of these financial statements.

Corporation Balance Sheet

at 31 December 2005 (Expressed in Hong Kong dollars)

	Note	**2005** **$ million**	2004 Restated $ million
Assets			
Fixed assets	14		
– Property, plant and equipment		**60,086**	60,979
– Investment properties		**1,171**	1,026
		61,257	62,005
Interest in leasehold land held for own use under operating leases	14	**5,645**	5,691
Construction in progress	15	**10,411**	6,991
Deferred expenditure	16	**1,210**	1,462
Properties under development	17	**1,537**	1,892
Interest in associate	19	**42**	9
Loans to third party	20	**–**	16
Loan to non-controlled subsidiary	21	**3,863**	3,576
Derivative financial assets	33(e)	**129**	–
Investments	22	**449**	4,323
Stores and spares	23	**343**	319
Interest and other receivables	24	**707**	751
Cash and cash equivalents	25	**3,270**	3,426
		88,863	90,461
Liabilities			
Interest and other payables	26	**2,664**	2,811
Accrued charges and provisions for capital projects	27	**3,038**	3,971
Derivative financial liabilities	33(e)	**361**	–
Interest-bearing borrowings	29	**19,474**	19,748
Deferred income	30	**501**	663
Deferred tax liabilities	10(d)	**3,198**	3,251
		29,236	30,444
Net Assets		**59,627**	60,017
Capital and Reserves			
Share capital	31	**39,120**	39,120
Reserves	32	**20,507**	20,897
Total equity		**59,627**	60,017

Approved and authorised for issue by the Managing Board on 27 February 2006.

Michael Tien
Samuel Lai
Patrick B Paul
Members of the Managing Board

The notes on pages 100 to 170 form part of these financial statements.

Consolidated Statement of Changes in Equity

for the year ended 31 December 2005 (Expressed in Hong Kong dollars)

	Note	**2005** **$ million**	2004 Restated $ million
Total equity at 1 January			
As previously reported		**60,147**	60,205
Prior period adjustments arising from changes in accounting policies in respect of:			
– depreciation of permanent way	3(a)(ii)	**(38)**	–
– deferred tax of valuation gains on investment properties	3(a)(ii) & 3(a)(iii)	**(47)**	(21)
As restated, before opening balance adjustments		**60,062**	60,184
Opening balance adjustments arising from changes in accounting policies under HKAS 32 and HKAS 39	32	**(568)**	
At 1 January, after prior period and opening balance adjustments		**59,494**	
Net income/(expenses) recognised directly in equity:			
Surplus on revaluation of investment properties, net of deferred tax			
– as previously reported			148
– prior period adjustments arising from changes in accounting policies in respect of valuation gains on investment properties	3(a)(i)		(148)
– surplus on revaluation of investment properties, net of deferred tax (2004: as restated)			–
Deficit on revaluation of available-for-sale securities	32	**(15)**	(54)
Net expenses for the year recognised directly in equity (2004: as restated)		**(15)**	(54)

The notes on pages 100 to 170 form part of these financial statements.

Consolidated Statement of Changes in Equity

for the year ended 31 December 2005 (continued) (Expressed in Hong Kong dollars)

	Note	**2005** **$ million**	2004 Restated $ million
Net profit for the year:			
– as previously reported			429
– prior period adjustments arising from changes in accounting policies for:			
> valuation gains on investment properties	3(a)(i)		148
> depreciation on permanent way	3(a)(i)		(38)
> deferred tax of valuation gains on investment properties	3(a)(i)		(26)
> restatement for the year			84
– net profit for the year (2004: as restated)	32	**317**	513
Revaluation deficit transferred to the income statement on redemption and disposal of available-for-sale securities	32	**29**	39
Dividend approved and paid during the year	12(b)	**(172)**	(620)
Total equity at 31 December		**59,653**	60,062

The notes on pages 100 to 170 form part of these financial statements.

Consolidated Cash Flow Statement

for the year ended 31 December 2005 (Expressed in Hong Kong dollars)

	Note	2005 $ million	2004 Restated $ million
Operating activities			
Net cash inflow from operations	34	**2,408**	2,309
Net cash inflow/(outflow) from property development		**340**	(376)
Hong Kong profits tax paid		**(1)**	(1)
Net cash inflow from operating activities		**2,747**	1,932
Investing activities			
Increase in deposits with banks with maturity more than three months when placed		**(615)**	(740)
Payments for capital expenditure:			
– East Rail Extensions project		**(2,821)**	(4,534)
– other capital projects and purchase of fixed assets		**(2,168)**	(2,450)
Interest received		**750**	1,358
Dividend received from associate		**33**	–
Loan to non-controlled subsidiary		**(84)**	(24)
Loan to associate		**(33)**	–
Receipts on sales of fixed assets		**4**	–
Receipts on redemption and disposal of available-for-sale securities		**3,311**	6,740
Net cash inflow/(outflow) from investing activities		**(1,623)**	350
Net cash inflow before financing		**1,124**	2,282
Financing activities			
Net cash outflow on drawdown/repayment of loans		**(279)**	(273)
Dividend paid		**(172)**	(620)
Interest paid		**(1,392)**	(1,387)
Net cash flow relating to derivative financial instruments		**(13)**	138
Finance expenses paid		**(20)**	(26)
Net increase/(decrease) in cash and cash equivalents		**(752)**	114
Cash and cash equivalents at 1 January		**2,591**	2,477
Cash and cash equivalents at 31 December		**1,839**	2,591
Analysis of the balances of cash and cash equivalents			
Cash at bank and in hand	25	**42**	36
Deposits with banks with maturity of less than three months when placed	25	**1,797**	2,555
		1,839	2,591

The notes on pages 100 to 170 form part of these financial statements.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

1 Establishment of the Corporation

The Kowloon-Canton Railway Corporation ("the Corporation") was incorporated in Hong Kong under the Kowloon-Canton Railway Corporation Ordinance ("the Ordinance") on 24 December 1982 to undertake the operation of the Hong Kong section of the Kowloon-Canton Railway. The assets, rights and liabilities of the then existing railway were vested in the Corporation on 1 February 1983 in accordance with Section 7 of the Ordinance.

The Ordinance was amended in 1986, 1998 and 2001. The amendment in 1986 enabled the Corporation to construct and operate the Light Rail system. The amendment in 1998 expanded the Corporation's power by permitting the Corporation to construct and operate any additional railway that the Secretary for the Environment, Transport and Works (the Secretary for Transport at the time of amendment) may authorise the Corporation to construct. The amendment in December 2001 provided for the separation of the functions and duties of the Chairman from those of the Chief Executive Officer by creating the office of Chief Executive Officer. The Chief Executive Officer was also appointed as a member of the Managing Board.

2 Significant accounting policies

(a) Statement of compliance

Although not required to do so under the Ordinance, the Corporation has prepared these financial statements in accordance with all applicable Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and accounting principles generally accepted in Hong Kong. These financial statements also comply with the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited and the Hong Kong Companies Ordinance. A summary of the significant accounting policies adopted by the Corporation and its controlled subsidiaries (the "Group") is set out below.

The HKICPA has issued a number of new and revised HKFRSs that are effective or available for early adoption for accounting periods beginning on or after 1 January 2005. Information on the changes in accounting policies resulting from the initial application of these new and revised HKFRSs for the current and prior accounting periods reflected in these financial statements is provided in note 3.

(b) Basis of preparation of the financial statements

The measurement basis used in the preparation of the financial statements is the historical cost basis except where stated otherwise in the accounting policies set out below. The preparation of financial statements in conformity with HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets, liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the prevailing circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements with significant effect on the financial statements and estimates with significant risk of material adjustment are discussed in note 43.

2 Significant accounting policies *(continued)*

(c) Basis of consolidation

The consolidated financial statements comprise the Corporation and its controlled subsidiaries and the Group's interest in associate made up to 31 December each year.

The financial statements of certain subsidiaries held by the Corporation for the sole purpose of developing, on behalf of the Government of the Hong Kong Special Administrative Region ("the Government"), commercial or residential properties along the West Rail, Phase I route are excluded from the consolidation on the basis that these are not considered to be controlled subsidiaries as the Corporation has no effective control over nor beneficial interests in the net assets of these subsidiaries, other than the amount of capital provided. The Corporation is not entitled to any earnings distribution, nor is it required to ultimately fund any losses which may be sustained by these subsidiaries.

(d) Investments in subsidiaries

A subsidiary, in accordance with the Hong Kong Companies Ordinance, is a company in which the Group, directly or indirectly, holds more than half of the issued share capital or controls more than half the voting power or controls the composition of the board of directors. Subsidiaries are considered to be controlled if the Corporation has the power, directly or indirectly, to govern the financial and operating policies thereof so as to obtain benefits from their activities.

An investment in a controlled subsidiary is consolidated into the consolidated financial statements from the date that control commences until the date that control ceases. An investment in a non-controlled subsidiary is excluded from consolidation and is stated at cost less impairment losses, if any, in the Group's and Corporation's balance sheet.

Intra-group balances and transactions and any unrealised profits arising from intra-group transactions with controlled subsidiaries are eliminated in full in preparing the consolidated financial statements. Unrealised losses resulting from intra-group transactions with controlled subsidiaries are eliminated in the same way as unrealised gains but only to the extent that there is no evidence of impairment.

In the Corporation's balance sheet, an investment in a subsidiary is stated at cost less impairment losses, if any.

(e) Interest in associate

An associate is an entity in which the Group or Corporation has significant influence, but not control or joint control, over its management, including participation in the financial and operating policy decisions.

An investment in an associate is accounted for in the consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the associate's net assets. The consolidated income statement includes the Group's share of the post-acquisition and post-tax results of associates for the year.

Unrealised profits and losses resulting from transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associate, except where unrealised losses provide evidence of an impairment of the asset transferred, in which case they are recognised immediately in the income statement.

The results of the associates are included in the Corporation's income statement to the extent of dividends received and receivable, providing the dividend in respect of a period ending on or before that of the Corporation and the Corporation's right to receive the dividend is established before the balance sheet date.

In the Corporation's balance sheet, an investment in an associate is stated at cost less impairment losses, if any.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

2 Significant accounting policies *(continued)*

(f) Investments

Investments comprise:

(i) temporary investment of funds from the equity injection received and borrowings obtained specifically for the construction of the East Rail Extensions and Kowloon Southern Link before the funds are used for such purposes ("pre-funding investments"); and

(ii) investment of surplus funds from the Corporation's operations ("other investments").

All the pre-funding investments and other investments are available-for-sale investments and are recognised initially at fair value at the date of recognition plus transaction costs. The fair value is remeasured at the balance sheet date, with any resultant gain or loss accounted for as follows:

(i) changes in fair value of pre-funding investments, together with all income generated from such investments, including interest income, exchange gains or losses, impairment losses, realised gains or losses arising from transactions in derivative financial instruments entered into for hedging foreign currency pre-funding investments and gains or losses arising from the derecognition of such investments, are capitalised to the related projects; and

(ii) changes in fair value of other investments are recognised directly in the investments revaluation reserve, except for the related impairment losses and foreign exchange gains and losses, if any, which are recognised directly in the income statement. Where these investments are interest-bearing, interest calculated using the effective interest method is recognised in the income statement. When these investments are derecognised, the cumulative gain or loss previously recognised directly in the investments revaluation reserve is recognised in the income statement.

Investments are recognised/derecognised on the trade date, which is the date the Group or the Corporation commits to purchase/sell the investments or when the investments expire.

(g) Derivative financial assets and liabilities

The Group uses derivative financial instruments to hedge its exposure to foreign exchange and interest rate risks arising from operational, financing and investment activities. In accordance with its treasury policy, the Group does not hold or issue derivative financial instruments for trading purposes.

The currency swaps are designated as hedges of the variability in cash flows attributable to the foreign exchange risk of certain of the Group's interest-bearing borrowings denominated in foreign currencies and recognised in the financial statements.

The interest rate swaps are designated as hedges of the variability in the fair value attributable to interest rate risk of certain of the Group's fixed rate interest-bearing borrowings recognised in the financial statements.

All the Group's derivative financial instruments are recognised initially as derivative financial assets or liabilities at fair value. The fair value is remeasured at the balance sheet date, with any resultant gain or loss on remeasurement to fair value recognised immediately in the income statement.

2 Significant accounting policies *(continued)*

(h) Investment properties

Investment properties comprise land and/or buildings which are owned or held under a leasehold interest to earn rental income and are held for their investment potential.

Investment properties are stated in the balance sheet at fair value. Any gain or loss arising from a change in fair value is recognised in the income statement.

Gains or losses arising from the retirement or disposal of an investment property are determined as the difference between the net disposal proceeds and the carrying amount of the item and are recognised in the income statement on the date of retirement or disposal.

(i) Property, plant and equipment

(i) Property, plant and equipment is stated in the balance sheet at cost less accumulated depreciation and impairment losses, if any.

Property, plant and equipment utilised in the operation of rail networks and ancillary commercial activities comprises:

– buildings held for own use which are situated on leasehold land, where the fair value of the building could be measured separately from the fair value of the leasehold land at the inception of the lease; and

– other items of plant and equipment.

The cost of property, plant and equipment vested by the Government has been determined as follows:

– for property, plant and equipment vested on 1 February 1983 - as determined by the Financial Secretary; and

– for property, plant and equipment vested subsequent to 1 February 1983 - based on actual cost as reflected in the Government's records.

The cost of property, plant and equipment acquired by the Corporation comprises:

– its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;

– any costs, such as the costs of material, direct labour, an appropriate proportion of production overheads and interest and finance income/expenses directly attributable to bringing the asset to the location and condition capable of operating in the manner intended by management; and

– the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, where the obligation is incurred by the Group when the item is acquired.

Expenditure on property, plant and equipment below $20,000 per item is expensed to the income statement as incurred.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

2 Significant accounting policies *(continued)*

(i) Property, plant and equipment *(continued)*

(ii) Subsequent expenditure on existing property, plant and equipment is added to the carrying amount of the asset if, either future economic benefits will flow to the Group or Corporation, or the condition of the asset will improve beyond its originally assessed standard of performance.

Expenditure on repairs or maintenance of existing property, plant and equipment to restore or maintain the originally assessed standard of performance of the asset is recognised as an expense when incurred.

(iii) Gains or losses arising from the retirement or disposal of an item of property, plant and equipment are determined as the difference between the net disposal proceeds and the carrying amount of the item and are recognised in the income statement on the date of retirement or disposal.

(j) Depreciation

(i) Depreciation is calculated to write off the cost of an item of property, plant and equipment less its estimated residual value, if any, using the straight-line basis over its estimated useful life as follows:

	No. of years
Tunnels, bridges and roads (see note 2(j)(iii))	43-65
Buildings (see note 2(j)(iii))	50
Rolling stock	30-40
Locomotives and wagons	15-35
Lifts and escalators	20
Permanent way comprising rails, ballast, sleepers and concrete civil works (see note 2(j)(iii))	10-50
Machinery and equipment	10-30
Telecommunication and signalling systems and air-conditioning plant	10-15
Fare collection systems	15
Mobile phone systems	7-10
Furniture and fixtures	3-15
Computer and office equipment (including computer software)	3-5
Buses	10-17
Other motor vehicles	4-15

(ii) Where parts of an item of property, plant and equipment have different useful lives, the cost of the item is allocated on a measurable basis between the parts and each part is depreciated separately. Both the useful life of an asset and its residual value, if any, are reviewed annually. The residual value of an asset is the estimated amount that the Corporation would currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset was already of the age and in the condition expected at the end of its useful life.

(iii) Tunnels, bridges, roads, concrete civil works and buildings situated on leasehold land are depreciated over the shorter of the unexpired term of the related lease and their estimated useful lives.

(k) Leased assets

(i) Classification of leased assets

Leases of assets under which the lessee assumes substantially all the risks and rewards of ownership are classified as finance leases. Leases of assets under which the lessor has not transferred substantially all the risks and rewards of ownership are classified as operating leases, except that property held under an operating lease that would otherwise meet the definition of an investment property may be classified as an investment property on a property-by-property basis.

2 Significant accounting policies *(continued)*

(k) Leased assets *(continued)*

(ii) Assets leased out under operating leases

Where the Group leases out assets under operating leases, the assets are included in the balance sheet according to their nature and, where applicable, are depreciated in accordance with the Group's depreciation policies.

(iii) Operating lease charges

Where the Group has the use of assets held under operating leases, payments made under the leases are charged to the income statement in equal instalments over the accounting periods covered by the lease term, except where an alternative basis is more representative of the pattern of benefits to be derived from the leased asset.

Land lease premiums, land resumption costs and other costs directly associated with the acquisition of leasehold land held for own use under operating leases are amortised on a straight-line basis over the period of the lease term. The cost in relation to leasehold land vested by the Government has been determined as follows:

– vested on 1 February 1983 - as determined by the Financial Secretary; and

– vested subsequent to 1 February 1983 - based on actual cost as reflected in the Government's records or the costs incurred by the Corporation directly associated with the acquisition of leasehold land.

(l) Impairment of assets

(i) Impairment of financial assets

All financial assets are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If any such evidence exists, an impairment loss is determined and recognised as follows:

– For interest and other receivables, loans to third party and loan to non-controlled subsidiary, an impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (taking into account bad and doubtful debts), discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at the date of initial recognition of these assets), except where the present value is not determinable as it does not have fixed repayment terms.

– For investments, losses on revaluation are initially recognised directly in equity, or capitalised to the construction in progress or deferred expenditure where the losses are attributable to pre-funding investments relating to the equity injection received and borrowings obtained specifically for railway projects. If evidence of impairment exists, the cumulative loss that had been recognised directly in equity is removed from equity and is recognised in the income statement as an impairment loss. However, the impairment loss relating to the cumulative loss that had been capitalised to construction in progress or deferred expenditure is not required to be charged to the income statement. The impairment loss recognised in subsequent years is accounted for as the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss previously recognised in the income statement and/or related cumulative loss capitalised to the construction in progress or deferred expenditure.

– Impairment losses are reversed if the subsequent increase in fair value can be objectively related to an event occurring after the impairment loss was recognised. Reversals of impairment losses in such circumstances are recognised in the income statement to the extent that the cumulative impairment loss has been charged to the income statement.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

2 Significant accounting policies *(continued)*

(l) Impairment of assets *(continued)*

(ii) Impairment of other assets

Internal and external sources of information are reviewed at each balance sheet date to identify indications that the following assets may be impaired or an impairment loss previously recognised no longer exists or may have decreased:

– property, plant and equipment;
– construction in progress;
– deferred expenditure;
– properties under development;
– investments in subsidiaries; and
– interest in associate.

If any such indication exists, the asset's recoverable amount is estimated.

– Calculation of recoverable amount

The recoverable amount of an asset is the greater of its net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of time value of money and the risks specific to the asset. Where an asset does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the smallest group of assets that generates cash inflows independently (i.e. a cash-generating unit).

– Recognition of impairment losses

An impairment loss is recognised in the income statement whenever the carrying amount of an asset, or the cash-generating unit to which it belongs, exceeds its recoverable amount. Impairment losses recognised in respect of cash-generating units are allocated to reduce the carrying amount of the other assets in the unit (or group of units) on a pro rata basis, except that the carrying value of an asset will not be reduced below its individual fair value less costs to sell, or value in use, if determinable.

– Reversals of impairment losses

An impairment loss is reversed if there has been a favourable change in the estimates used to determine the recoverable amount.

A reversal of an impairment loss is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years. Reversals of impairment losses are credited to the income statement in the year in which the reversals are recognised.

(m) Construction in progress

Assets under construction and capital works for the operating railways are stated at cost less impairment losses, if any. Costs comprise direct costs of construction, such as materials, staff costs and overheads, interest and finance income/expenses and gain or loss arising from change in fair value of pre-funding investments capitalised during the period of construction or installation and testing. Capitalisation of these costs is suspended or ceases when substantially all the activities necessary to prepare the qualifying asset for its intended use are interrupted or completed. The assets concerned are transferred to fixed assets when substantially all the activities necessary to prepare the assets for their intended use are completed, at which time the assets begin to be depreciated in accordance with the relevant policies. Land lease premiums, land resumption costs and other related costs incurred by the Corporation for the purpose of acquiring the land on which the new railways or extensions to existing railways are to be operated are initially included in construction in progress. These costs are transferred to interest in leasehold land held for own use under operating leases when the land is vested in the Corporation by the Government, at which time the costs begin to be amortised in accordance with the relevant policies.

2 Significant accounting policies *(continued)*

(m) Construction in progress *(continued)*

Costs incurred by the Corporation in respect of feasibility studies on proposed railway related construction projects (including consultancy fees, in-house staff costs and overheads) are dealt with as follows:

– where the proposed projects are at a preliminary review stage with no certainty of the proposed project proceeding, the costs concerned are written off to the income statement as incurred; and

– where the proposed projects are at a detailed study stage, having demonstrated an acceptable financial viability and having obtained the Managing Board's approval to proceed further, the costs concerned are initially dealt with as deferred expenditure and then transferred to construction in progress after the relevant project agreements are reached with the Government.

(n) Deferred expenditure

Deferred expenditure relates to costs incurred for proposed railway related construction projects which will be transferred to construction in progress after the relevant project agreements are reached with the Government.

(o) Property development

The Corporation is involved in a number of property development projects. When the Corporation determines or reaches agreement with property developers to develop a site for resale or for rent, the carrying amount of the leasehold land and existing buildings on the development site are transferred to properties under development. Costs related to the respective projects incurred by the Corporation are also dealt with as properties under development until such time that profit on the development is recognised by the Corporation.

Profits on property development undertaken in conjunction with property developers are recognised in the income statement as follows:

– where the Corporation receives payments from property developers as a consequence of their participation in a project to develop a property, such payments are set off against the balance in properties under development in respect of that project. Any surplus amounts of payments received from property developers in excess of the balance in properties under development are transferred to deferred income. In such circumstances, further costs subsequently incurred by the Corporation in respect of that project are charged against the related balance of deferred income and any excess is charged to properties under development to the extent it is considered to be recoverable. The balance of deferred income is credited to income statement when the property enabling works are completed and acceptable for development, and after taking into account the outstanding risks and obligations in connection with the development, if any, retained by the Corporation. The balance of properties under development not previously offset by payments received from property developers is charged to the income statement where the costs are considered to be irrecoverable, together with provision for losses, if any, borne by the Corporation in respect of the development;

– where the Corporation receives a share of profits from the sale of properties, profits are recognised upon the issue of occupation permits provided the amounts of revenue and related costs can be measured reliably; and

– where the Corporation retains certain assets of the development, profits are measured based on the fair value of such assets and are recognised at the time of receipt after taking into account the costs incurred by the Corporation in respect of the development and the outstanding risks, if any, retained by the Corporation in connection with the development.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

2 Significant accounting policies *(continued)*

(p) Jointly controlled operations

Assets that the Corporation owns and the liabilities that it incurs for the purpose of jointly controlled operations are recognised in the balance sheet and classified according to the nature of the relevant item. The Corporation's share of revenue from the jointly controlled operations along with the expenses that it incurs are included in the income statement when it is probable that economic benefits associated with the transactions will flow to or from the Corporation, as applicable.

Jointly controlled operations include intercity train services to and from Hong Kong and Mainland China which are jointly provided by the Corporation and its Mainland China railway counterparts. The related revenue sharing arrangements are negotiated and agreed between the relevant parties on commercial terms with reference to the ratio of distance travelled within Hong Kong and Mainland China for each route. The term of the revenue sharing arrangements is not fixed but either party is entitled to terminate the operation with advance notice.

(q) Loans to third party

Loans to third party are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arose when the Group advanced funds directly to a third party pursuant to lease out and lease back transaction. There is no intention that such leases will be traded. Loans to third party are initially recognised at fair value and thereafter are stated at amortised cost using the effective interest method less impairment losses, if any.

(r) Loan to non-controlled subsidiary

Loan to non-controlled subsidiary is a non-derivative financial asset without fixed or determinable repayment terms and is not quoted in an active market. It arose when the Group entered into a shareholding agreement with the Government for the formation of a sub-group of the Corporation under an intermediate holding company, West Rail Property Development Limited ("WRPDL"), to undertake all property developments along the West Rail, Phase I route. Loan to non-controlled subsidiary is initially recognised at fair value and thereafter is stated at cost instead of amortised cost less impairment losses, if any.

(s) Stores and spares

Stores and spares are valued at cost of purchase on a weighted average basis. Obsolete stores and spares are written off to the income statement. When stores and spares are consumed, the carrying amount of those stores and spares is recognised as an expense in the year in which the consumption occurs.

(t) Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and on hand, demand deposits with banks and other financial institutions and short-term, highly liquid investments. Cash equivalents are readily convertible into known amounts of cash with an insignificant risk of changes in value and have a maturity of less than three months at acquisition.

For the purposes of the consolidated cash flow statement, cash equivalents would exclude bank deposits with a maturity of more than three months when placed but include bank overdrafts that are repayable on demand and form an integral part of the Group's cash management.

(u) Interest and other receivables

Interest and other receivables are initially recognised at fair value and thereafter are stated at amortised cost less impairment losses, if any, except where the present value is not determinable because there is no fixed repayment term. In such cases, the interest and other receivables are stated at cost less impairment losses, if any.

2 Significant accounting policies *(continued)*

(v) Interest-bearing borrowings

Interest-bearing borrowings are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, the unhedged portion of interest-bearing borrowings is stated at amortised cost with any difference between the cost and redemption value being recognised in the income statement over the period of the borrowings using the effective interest method.

Subsequent to initial recognition, the carrying amount of the hedged portion of interest-bearing borrowings is remeasured and the change in fair value attributable to the risk being hedged is recognised in the income statement to offset the effect of the gain or loss on the related hedging instrument.

(w) Lease payable

Lease payable arising from a lease out and lease back transaction is initially recognised at fair value and thereafter is stated at amortised cost using the effective interest method.

(x) Interest and other payables

Interest and other payables are initially recognised at fair value and thereafter are stated at amortised cost except where the present value is not determinable because there are no fixed payment terms. In such cases, the other payables are stated at cost.

(y) Employee benefits

(i) Short term employee benefits and contributions to defined contribution retirement plans

Salaries, annual bonuses, paid annual leave, contributions to defined contribution retirement plans and the cost of non-monetary benefits are accrued in the year in which the associated services are rendered by employees.

(ii) Termination benefits

Termination benefits are recognised when, and only when, the Group demonstrably commits itself to terminate employment or to provide benefits as a result of voluntary redundancy by having a detailed formal plan which is without realistic possibility of withdrawal.

(z) Income tax

(i) Income tax for the year comprises current tax and movements in deferred tax assets and liabilities. Current tax and movements in deferred tax assets and liabilities are recognised in the income statement except to the extent that they relate to items recognised directly to equity, in which case they are recognised in equity.

(ii) Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the balance sheet date and any adjustment to tax payable in respect of previous years.

(iii) Deferred tax assets and liabilities arise from deductible and taxable temporary differences respectively, being the differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts for tax purposes. Deferred tax assets also arise from unused tax losses and unused tax credits.

All deferred tax assets, to the extent that it is probable that future taxable profits will be available against which the assets can be utilised, are recognised. All deferred tax liabilities are recognised.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

2 Significant accounting policies *(continued)*

(z) Income tax *(continued)*

The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of the assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date. Deferred tax assets and liabilities are not discounted.

The carrying amount of a deferred tax asset is reviewed at each balance sheet date and is reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow the related tax benefit to be utilised. Such reduction is reversed to the extent that it becomes probable that sufficient taxable profits will be available.

(iv) Current tax balances and deferred tax balances, and movements therein, are presented separately from each other and are not offset. Current tax assets are offset against current tax liabilities, and deferred tax assets against deferred tax liabilities if the Group or Corporation has the legally enforceable right to set off current tax assets against current tax liabilities and the following additional conditions are met:

- in the case of current tax assets and liabilities, the Group or Corporation intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously; or

- in the case of deferred tax assets and liabilities, they relate to income taxes levied by the same taxation authority on either:

  - the same taxable entity; or

  - different taxable entities which intend to realise the current tax assets and settle the current tax liabilities on a net basis in the same period.

(aa) Provisions and contingent liabilities

Provisions are recognised for liabilities of uncertain timing or amount when the Group or the Corporation has a legal or constructive obligation arising as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made. Where the time value of money is material, provisions are stated at the present value of the expenditure expected to settle the obligation.

Where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably, the possibility of an obligation arising as a result of a past event is disclosed as a contingent liability, unless the probability of outflow of economic benefits is remote. Possible obligations, whose existence will only be confirmed by the occurrence or non-occurrence of one or more future events are also disclosed as contingent liabilities unless the probability of outflow of economic benefits is remote.

(ab) Revenue recognition

Provided it is probable that the economic benefits will flow to the Group and the revenue and costs, if applicable, can be measured reliably, revenue is recognised in the income statement as follows:

(i) Passenger and freight services

Revenue is recognised when the services are provided.

2 Significant accounting policies *(continued)*

(ab) Revenue recognition *(continued)*

(ii) Rental and licence income

Rental and licence income receivable under operating leases is recognised in the income statement in equal instalments over the periods covered by the lease term, except where an alternative basis is more representative of the pattern of benefits to be derived from the use of the leased asset. Lease incentives granted are recognised in the income statement as an integral part of the aggregate net lease payment receivable. Contingent rentals are recognised as income in the accounting period in which they are earned.

(iii) Interest income

Interest income is recognised as it accrues using the effective interest method.

(iv) Other income

Other income is recognised once the related services or goods are delivered and the related risks and rewards of ownership have been transferred.

(ac) Lease out and lease back transactions

A series of lease out and lease back transactions with third parties is linked and accounted for as one arrangement when the overall economic effect cannot be understood without reference to the series of transactions as a whole and when the series of transactions is closely interrelated, negotiated as a single arrangement and takes place concurrently or in a continued sequence.

The primary purpose of such arrangements is to achieve a particular tax result for the third parties in return for a fee. The arrangements do not, in substance, involve a lease under HKAS 17 since the Group retains all the risks and rewards incidental to the ownership of the underlying assets and enjoys substantially the same rights to their use as before the transactions were entered into. The transactions are, therefore, not accounted for as leases.

Where commitments to make long-term lease payments have been defeased by the placement of security deposits or by the advance of loans to third party, they are not recognised in the balance sheet. Where commitments and deposits or advances of loans to third party meet the definition of a liability and an asset, they are recognised in the balance sheet.

The income and expenses arising from the arrangements are accounted for on a net basis in order to reflect the overall commercial effect of the transactions. The net amounts are accounted for as deferred income and are amortised over the applicable lease terms of the transactions.

(ad) Translation of foreign currencies

Foreign currency transactions during the year are translated into Hong Kong dollars at the exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the foreign exchange rates ruling at the balance sheet date.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the foreign exchange rates ruling at the transaction dates. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated into Hong Kong dollars using the foreign exchange rates ruling at the dates the fair value was determined.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

2 Significant accounting policies *(continued)*

(ae) Interest and finance income/expenses

Interest and finance income includes:

(i) interest income from bank deposits, investments and loans to other parties;
(ii) realised gains arising from derivative financial instruments designated as hedges for borrowings;
(iii) net gains on redemption and disposal of investments; and
(iv) net exchange gain arising from foreign currency transactions.

All the Group's interest and finance income relates to non-derivative financial assets which are not classified as at fair value through the income statement.

Interest and finance income is credited to the income statement in the period in which it is earned, except for the portion generated from pre-funding investments which is credited to construction in progress or deferred expenditure, as appropriate.

Interest and finance expenses include:

(i) interest payable on borrowings and lease payable;
(ii) finance expenses including amortisation of discounts/premiums and ancillary costs incurred in connection with the arrangement of borrowings calculated using the effective interest rate;
(iii) realised losses arising from derivative financial instruments designated as hedges for borrowings;
(iv) net realised losses on redemption and disposal of investments; and
(v) net exchange losses arising from foreign currency transactions.

All the Group's interest and finance expenses relate to non-derivative financial liabilities which are not classified as at fair value through the income statement.

Interest and finance expenses are expensed in the income statement in the period in which they are incurred, except to the extent that they are capitalised as being directly attributable to the acquisition, construction or production of an asset which necessarily takes a substantial period of time to get ready for its intended use or sale.

(af) Related parties

For the purposes of these financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals (being members of key management personnel and/or their close family members) or other entities and include entities which are under the significant influence of related parties of the Group where those parties are individuals.

(ag) Segment reporting

A segment is a distinguishable component of the Group that is engaged either in providing products or services (business segment), or in providing products or services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other segments.

Business segment information is the primary reporting format in accordance with the Group's internal financial reporting. Segment revenue, expenses, results, assets and liabilities include items directly attributable to a segment as well as those that are allocated from other segments on a cost recovery basis.

Segment capital expenditure is the total cost incurred during the year to acquire segment assets.

2 Significant accounting policies *(continued)*

(ag) Segment reporting *(continued)*

Unallocated items mainly comprise financial and corporate assets, interest-bearing loans, borrowings, tax balances, corporate and financing expenses.

3 Changes in accounting policies

The HKICPA has issued a number of new and revised HKFRSs that are effective for accounting periods beginning on or after 1 January 2005.

The accounting policies of the Group and Corporation after the adoption of these new and revised HKFRSs have been summarised in note 2. The following sets out information on the significant changes in accounting policies for the current and prior accounting periods reflected in these financial statements.

The Group has not applied any new standard or interpretation that is not yet effective for the current accounting period.

(a) Prior period and opening balance adjustments

The following tables disclose the adjustments that have been made in accordance with the transitional provisions of the respective HKFRSs to each of the line items in the consolidated income statement and balance sheet, and other significant related disclosures items as previously reported for the year ended 31 December 2004.

(i) Effect on the consolidated income statement for the year ended 31 December 2004

		Increase/(decrease) in profit for the year					($ million)
	2004 (as previously reported)	HKAS 1 (note 3(c))	HKAS 17 (note 3(d))	HKAS 40 (note 3(f))	HKAS 16 (note 3(g))	HK(SIC)-Int 21 (note 3(f))	2004 (as restated)
Turnover	4,976	–	–	–	–	–	4,976
Operating costs before depreciation	(2,807)	–	(112)	–	3	–	(2,916)
Operating profit before depreciation	2,169	–	(112)	–	3	–	2,060
Depreciation	(1,632)	–	112	–	(49)	–	(1,569)
Operating profit before interest and finance income/expenses	537	–	–	–	(46)	–	491
Interest and finance income	444	–	–	–	–	–	444
Interest and finance expenses	(485)	–	–	–	–	–	(485)
Profit/(loss) after depreciation, interest and finance income/expenses	496	–	–	–	(46)	–	450
Valuation gains on investment properties	–	–	–	148	–	–	148
Share of profit of associate	16	(1)	–	–	–	–	15
Profit before taxation	512	(1)	–	148	(46)	–	613
Income tax	(83)	1	–	–	8	(26)	(100)
Profit for the year wholly attributable to the sole shareholder of the Corporation	429	–	–	148	(38)	(26)	513
Other significant disclosure items:							
– Amortisation of interest in leasehold land held for own use under operating leases	–	–	(112)	–	–	–	(112)

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

3 Changes in accounting policies *(continued)*

(a) Prior period and opening balance adjustments *(continued)*

(ii) Effect on consolidated balance sheet as at 31 December 2004

There is no material difference in the effect of new accounting policies between the Corporation and the Group and therefore separate details for the Corporation are not presented.

		Increase/(decrease) in net assets				($ million)
	2004 (as previously reported)	HKAS 17 (note 3(d))	HKAS 40 (note 3(f))	HKAS 16 (note 3(g))	HK(SIC)-Int 21 (note 3(f))	2004 (as restated)
Assets						
Fixed assets						
– Property, plant and equipment	66,766	(5,691)	–	(46)	–	61,029
– Investment properties	1,026	–	–	–	–	1,026
Interest in leasehold land held for own use under operating leases	–	5,691	–	–	–	5,691
Construction in progress	6,991	–	–	–	–	6,991
Deferred expenditure	1,462	–	–	–	–	1,462
Properties under development	1,892	–	–	–	–	1,892
Interest in associate	57	–	–	–	–	57
Loans to third party	733	–	–	–	–	733
Loan to non-controlled subsidiary	3,576	–	–	–	–	3,576
Investments	4,323	–	–	–	–	4,323
Stores and spares	319	–	–	–	–	319
Interest and other receivables	756	–	–	–	–	756
Cash and cash equivalents	3,531	–	–	–	–	3,531
	91,432	–	–	(46)	–	91,386
Liabilities						
Interest and other payables	(2,929)	–	–	–	–	(2,929)
Accrued charges and provisions for capital projects	(3,971)	–	–	–	–	(3,971)
Lease payable	(717)	–	–	–	–	(717)
Interest-bearing borrowings	(19,748)	–	–	–	–	(19,748)
Deferred income	(708)	–	–	–	–	(708)
Deferred tax liabilities	(3,212)	–	–	8	(47)	(3,251)
	(31,285)	–	–	8	(47)	(31,324)
Net assets	60,147	–	–	(38)	(47)	60,062
Capital and reserves						
Share capital	39,120	–	–	–	–	39,120
Development reserve	6,535	–	–	–	–	6,535
Investment property revaluation reserve	265	–	(265)	–	–	–
Investments revaluation reserve	(16)	–	–	–	–	(16)
Proposed dividend	172	–	–	–	–	172
Retained profits	14,071	–	265	(38)	(47)	14,251
Total equity	60,147	–	–	(38)	(47)	60,062

3 Changes in accounting policies *(continued)*

(a) Prior period and opening balance adjustments *(continued)*

(iii) Effect on opening balance of total equity of the Group at 1 January 2004

The following table sets out only those adjustments that have been made to the opening balances at 1 January 2004. Certain changes in accounting policies did not result in retrospective adjustments being made to the opening balances as at 1 January 2004 as this was prohibited or not required by the relevant transitional provisions.

		Increase/(decrease) in total equity		($ million)
	2004 (as previously reported)	HKAS 40 (note 3(f))	HK(SIC)-Int 21 (note 3(f))	2004 (as restated)
Capital and reserves				
Share capital	39,120	–	–	39,120
Development reserve	6,535	–	–	6,535
Investment property revaluation reserve	117	(117)	–	–
Investments revaluation reserve	(1)	–	–	(1)
Proposed dividend	620	–	–	620
Retained profits	13,814	117	(21)	13,910
Total equity	60,205	–	(21)	60,184

(iv) The net income recognised directly in equity for the year ended 31 December 2004 has decreased by $148 million as a result of the adoption of HKAS 40.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

3 Changes in accounting policies *(continued)*

(b) Estimated effect of changes in accounting policies on the current year

The following tables provide estimates of the extent to which those relevant items in the consolidated income statement and balance sheet, the Corporation's balance sheet and other related disclosure items in the notes to the financial statements are affected by the changes in accounting policies for the year ended 31 December 2005.

(i) Estimated effect on the relevant items in the consolidated income statement for the year ended 31 December 2005

	Increase/(decrease) in profit for the year							($ million)
	HKAS 1 (note 3(c))	**HKAS 17 (note 3(d))**	**HKAS 32 & 39 (note 3(e))**	**HKAS 40 (note 3(f))**	**HKAS 16 (note 3(g))**	**HK-Int 4 (note 3(h))**	**HK(SIC)-Int 21 (note 3(f))**	**Total**
Operating costs before depreciation	–	(118)	–	–	20	–	–	(98)
Depreciation	–	118	–	–	(121)	(178)	–	(181)
Interest and finance income	–	–	24	–	–	–	–	24
Interest and finance expenses	–	–	(4)	–	–	–	–	(4)
Gains on changes in fair value of derivative financial instruments and hedged borrowings	–	–	400	–	–	–	–	400
Valuation gains on investment properties	–	–	–	171	–	–	–	171
Share of profit of associate	(3)	–	–	–	–	–	–	(3)
Income tax	3	–	(74)	–	18	31	(30)	(52)
Profit for the year wholly attributable to the sole shareholder of the Corporation	–	–	346	171	(83)	(147)	(30)	257
Other significant disclosure items:								
– Amortisation of interest in leasehold land held for own use under operating leases	–	(118)	–	–	–	–	–	(118)

3 Changes in accounting policies *(continued)*

(b) Estimated effect of changes in accounting policies on the current year *(continued)*

(ii) Estimated effect on the relevant items in the consolidated and Corporation's balance sheet as at 31 December 2005

	Increase/(decrease) in net assets						($ million)
	HKAS 17 (note 3(d))	HKAS 32 & 39 (note 3(e))	HKAS 40 (note 3(f))	HKAS 16 (note 3(g))	HK-Int 4 (note 3(h))	HK(SIC)-Int 21 (note 3(f))	Total
Assets							
Fixed assets							
– Property, plant and equipment	(5,645)	–	–	(147)	(178)	–	(5,970)
Interest in leasehold land held for own use under operating leases	5,645	–	–	–	–	–	5,645
Construction in progress	–	(24)	–	–	–	–	(24)
Deferred expenditure	–	(1)	–	–	–	–	(1)
Derivative financial assets	–	129	–	–	–	–	129
	–	104	–	(147)	(178)	–	(221)
Liabilities							
Derivative financial liabilities	–	(361)	–	–	–	–	(361)
Interest-bearing borrowings	–	(12)	–	–	–	–	(12)
Deferred tax liabilities	–	47	–	26	31	(77)	27
	–	(326)	–	26	31	(77)	(346)
Net assets	–	(222)	–	(121)	(147)	(77)	(567)
Capital and reserves							
Investment property revaluation reserve	–	–	(436)	–	–	–	(436)
Retained profits	–	(222)	436	(121)	(147)	(77)	(131)
Total equity	–	(222)	–	(121)	(147)	(77)	(567)

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

3 Changes in accounting policies *(continued)*

(b) Estimated effect of changes in accounting policies on the current year *(continued)*

(iii) Effect on opening balance of total equity of the Group and the Corporation at 1 January 2005

($ million)

	Balance as at 31 December 2004 (as restated) (see note 3(a)(ii))	Opening balance adjustment HKAS 32 and 39	Balance as at 1 January 2005 (as adjusted)
Capital and reserves			
Share capital	39,120	–	39,120
Development reserve	6,535	–	6,535
Investments revaluation reserve	(16)	–	(16)
Proposed dividend	172	–	172
Retained profits	14,251	(568)	13,683
Total equity	60,062	(568)	59,494

(iv) The net income which would have been recognised directly in equity for the year ended 31 December 2005 is estimated to have decreased by $171 million as a result of the adoption of HKAS 40.

(c) Changes in presentation (HKAS 1, Presentation of financial statements)

In prior years, the Group's share of taxation of an associate was included as part of the Group's income tax in the consolidated income statement using the equity method of accounting. With effect from 1 January 2005, in accordance with the implementation guidance in HKAS 1, the Group has changed the presentation such that the share of taxation of an associate is excluded from the Group's income tax in the consolidated income statement. Instead, the share of profit after taxation of associate is included in the consolidated income statement using the equity method of accounting before arriving at the Group's profit before taxation. These changes in presentation have been applied retrospectively with comparatives restated.

(d) Leasehold land (HKAS 17, Leases)

(i) Leasehold land held for own use

In prior years, leasehold land and buildings held for own use were stated at cost less accumulated depreciation and accumulated impairment losses, if any.

With effect from 1 January 2005, in order to comply with HKAS 17, the Group has adopted a new policy for leasehold land held for own use. Under the new policy, the leasehold interest in land held for own use is accounted for as being held under an operating lease when the value of the leasehold interest in the land was able to be measured separately from the value of the building at the time the lease was first entered into by the Group or taken over from the previous lessee or at the date of construction of those buildings, if later.

Land lease premiums, land resumption costs and other costs directly associated with the acquisition of the leasehold land are amortised on a straight-line basis over the lease term except where the property is classified as investment property. If the land is in the course of development or re-development, the carrying amount of the leasehold land and the related amortised charge is included as part of the costs of the construction in progress or property under development, where appropriate. In all other cases the amortisation charge for the period is recognised in the income statement immediately.

3 Changes in accounting policies *(continued)*

(d) Leasehold land (HKAS 17, Leases) *(continued)*

For a leasehold interest in land where the value of the land could not be measured separately from the value of the building at the time when the lease was first entered into, such lease continues to be presented as part of land and building under property, plant and equipment.

(ii) Effect of changes in accounting policies

The above new accounting policies relating to leases have been adopted retrospectively.

(e) Financial instruments (HKAS 32, Financial instruments: Disclosure and presentation and HKAS 39, Financial instruments: Recognition and measurement)

With effect from 1 January 2005, in order to comply with HKAS 32 and HKAS 39, the Group has changed its accounting policies relating to financial assets and liabilities. Details of the changes are as follows.

(i) Investments

In prior years, investments were classified as investments held for non-trading purposes and were stated at fair value with changes in fair value recognised in the investments revaluation reserve.

With effect from 1 January 2005, and in accordance with HKAS 39, all investments are classified as available-for-sale securities and carried at fair value. Changes in the fair value of available-for-sale securities are recognised in investments revaluation reserve except to the extent that they are capitalised as being directly attributable to the acquisition, construction or production of an asset which necessarily takes a substantial period of time to get ready for its intended use. There is no financial effect of this change in accounting policy.

(ii) Interest-bearing borrowings

In prior years, the discount/premium and ancillary costs arising from interest-bearing borrowings were amortised to the income statement on a straight-line basis.

With effect from 1 January 2005, and in accordance with HKAS 39, the discount/premium and ancillary costs arising from interest-bearing borrowings are amortised to the income statement using the effective interest rate.

(iii) Derivative financial assets and liabilities

In prior years, derivative financial instruments entered into by management to hedge the interest rate risk and foreign currency risk of a recognised liability were recognised with reference to the timing of recognition of the corresponding hedged transaction. Derivative financial instruments entered into for the purpose of hedging the foreign currency risk of a recognised foreign currency liability were revalued at the balance sheet date at the exchange rates ruling at that date with the resultant gains and losses used to offset gains and losses resulting from currency fluctuations inherent in the underlying foreign currency liabilities.

With effect from 1 January 2005, and in accordance with HKAS 39, all derivative financial instruments entered into by the Group are stated at fair value. Changes in the fair value of derivative financial instruments designated as hedging instruments in a cash flow hedge are recognised directly in the income statement in the same period or periods during which the liability affects the income statement (such as when the interest income or expense is recognised).

Changes in fair value of derivative financial instruments designated as hedging instruments in a fair value hedge are recognised in the income statement. Changes in fair value of derivative financial instruments which do not qualify as hedging instruments are recognised in the income statement.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

3 Changes in accounting policies *(continued)*

(e) Financial instruments (HKAS 32, Financial instruments: Disclosure and presentation and HKAS 39, Financial instruments: Recognition and measurement) *(continued)*

(iv) Effect of the changes in accounting policies

The changes in accounting policies relating to accounting for investments in securities and derivative financial assets and liabilities were adopted by way of opening balance adjustments to certain reserves as at 1 January 2005. Comparative amounts have not been restated as this is prohibited by the transitional arrangements in HKAS 39.

(f) Investment properties (HKAS 40, Investment property, and HK(SIC) Interpretation 21, Income taxes – Recovery of revalued non-depreciable assets)

(i) Timing of recognition of movements in fair value in the income statement

In prior years, movements in the fair value of the Group's investment properties were recognised directly in the investment property revaluation reserve except when, on a portfolio basis, the reserve was insufficient to cover a deficit on the portfolio, or when a deficit previously recognised in the income statement had reversed, or when an individual investment property was disposed of. In these limited circumstances, movements in the fair value were recognised in the income statement.

Upon adoption of HKAS 40 with effect from 1 January 2005, the Group has adopted a new policy for investment properties. Under this new policy, all changes in the fair value of investment property are recognised directly in the income statement in accordance with the fair value model in HKAS 40.

(ii) Measurement of deferred tax on movements in fair value

In prior years, the Group was required to apply the tax rate that would be applicable upon the sale of investment property to determine whether any amounts of deferred tax should be recognised on the revaluation of investment property. Consequently, deferred tax was only provided to the extent that tax allowances already given would be clawed back if the property was disposed of at its carrying value, as there would be no additional tax payable on disposal.

With effect from 1 January 2005, in accordance with HK(SIC) Interpretation 21, the Group recognises deferred tax on movements in the value of an investment property using tax rates that are applicable to the property's use, if the Group has no intention to sell it and the property would have been depreciable had the Group not adopted the fair value model.

(iii) Effect of changes in accounting policies

The above changes in accounting policies relating to investment property have been adopted retrospectively.

(g) Depreciation of permanent way (HKAS 16, Property, plant and equipment)

(i) In prior years, the Corporation's permanent way, which principally comprises rail tracks, ballast and sleepers, was not depreciated as these assets were subject to continuing maintenance, repairs and replacement to maintain them in their optimal working condition. All costs of maintenance, repairs and replacement of such assets were charged to the income statement as incurred. This accounting treatment is no longer accepted under the newly issued accounting standard HKAS 16 and an Interpretation thereof issued by the HKICPA in 2005 which stipulates that all items of property, plant and equipment should be depreciated over their estimated economic useful lives.

3 Changes in accounting policies *(continued)*

(g) Depreciation of permanent way (HKAS 16, Property, plant and equipment) *(continued)*

Accordingly, with effect from 1 January 2005, permanent way is depreciated over the shorter of the unexpired term of land lease on which the permanent way is anchored and its estimated economic useful life and the related replacement costs are capitalised.

(ii) Effect of changes in accounting policies

Retrospective adjustments were made for all the permanent way of the Corporation except for the original permanent way, which comprises the East Rail network and the Light Rail network, as the original permanent way would have been substantially depreciated by 1 January 2004. The Corporation estimated that the difference between the replacement costs charged to the income statement and the depreciation that would have been charged in prior years is not significant. In addition, the original cost of permanent way would have been substantially depreciated in prior years whilst the costs of replacement of permanent way incurred on an annual basis would have been capitalised and depreciated over the estimated useful life of the replacements. Management consider that for the original permanent way of the Corporation and the subsequent replacement thereof, the costs charged to the income statement approximate the estimated depreciation which would have been charged to the income statement and that any differences are not material. Accordingly, adjustments have only been made on a prospective basis for the original permanent way.

(h) Depreciation of property, plant and equipment situated on leasehold land (HK-Int 4, Leases - Determination of the length of lease term in respect of Hong Kong land leases)

(i) The adoption of HK-Int 4 has resulted in a change in accounting policy for depreciation of property, plant and equipment situated on leasehold land. HK-Int 4 states that the lease term of a Hong Kong land lease shall be determined by reference to the legal form and status of the lease. The Interpretation also states that lessees shall not assume that the lease term of a Hong Kong land lease will be extended for a further 50 years, or any other period, while the Government retains the sole discretion as to whether to renew the lease or not. Accordingly, property, plant and equipment situated on leasehold land should be depreciated over a period which does not exceed the term of the lease. The depreciation charge of certain buildings, tunnels, bridges and roads has been adjusted to comply with this interpretation.

(ii) Effect of changes in accounting policies

The above changes in accounting policies relating to depreciation of property, plant and equipment situated on leasehold land have been adopted prospectively.

(i) Definition of related parties (HKAS 24, Related party disclosures)

As a result of the adoption of HKAS 24, the definition of related parties has been expanded to include entities that are under the significant influence of a related party that is an individual (i.e. key management personnel and/or their close family members). The expanded definition of related parties has not resulted in any material changes to the previously reported disclosures of related party transactions nor has any material effect on the disclosures made in the current period, as compared to those that would have been reported had SSAP 20, Related party disclosures, still been in effect.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

4 Turnover

Turnover represents the revenue from passenger, freight and property services after eliminating inter-company transactions. The amounts of revenue recognised in turnover classified by principal activity during the year are as follows:

	2005 $ million	2004 $ million
Transport services		
Passenger services		
– East Rail	**3,670**	3,415
– West Rail and Light Rail	**890**	798
Freight services	**52**	68
	4,612	4,281
Property services	**771**	695
	5,383	4,976

5 Operating costs before depreciation

	2005 $ million	2004 Restated $ million
Staff costs		
– Gross amount including retirement costs of $135 million (2004: $138 million) after a forfeiture of unvested contributions of $2 million (2004: $3 million)	**2,068**	2,154
– Staff costs capitalised	**(547)**	(692)
	1,521	1,462
Electricity and fuel	**495**	456
Repairs and maintenance	**265**	180
Stores and spares consumed	**181**	158
General supplies	**33**	32
Government rent and rates	**82**	68
Octopus cards usage fees	**36**	33
Cost of services acquired	**150**	144
Property ownership and management expenses	**84**	63
Amortisation of interest in leasehold land held for own use under operating leases	**118**	112
Others	**180**	208
	3,145	2,916

6 Operating profit before depreciation

(a) Operating profit before depreciation is arrived at after charging:

	2005 $ million	2004 $ million
Fixed assets written off on disposal	**43**	24
Auditors' remuneration		
– Audit services	**4**	4
– Tax compliance services	**1**	1
– Other services	**4**	–
Operating lease charges (minimum lease payments)		
– Hire of plant and machinery	**28**	29
– Rental of property	**8**	13
Remuneration of Members of the Managing Board and Executive Directors who are not Members of the Managing Board		
– Fees for Members of the Managing Board including the Chairman but excluding the Chief Executive Officer	**1**	1
– Contributions to retirement benefit schemes for the Chief Executive Officer and Executive Directors who are not Members of the Managing Board	**1**	1
– Emoluments of the Chief Executive Officer and Executive Directors who are not Members of the Managing Board	**25**	34
and after crediting:		
Rentals receivable from operating leases less direct outgoings of $16 million (2004: $17 million) (including contingent rentals of $39 million (2004: $29 million))	**642**	551
Rentals receivable from investment properties less direct outgoings of $14 million (2004: $18 million)	**38**	62

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

6 Operating profit before depreciation *(continued)*

(b) Fees for Members of the Managing Board including the Chairman but excluding the Chief Executive Officer are shown below:

	2005 $ thousand	2004 $ thousand
Chairman		
Mr Michael P S Tien	**220**	220
Members		
Mr Vincent H C Cheng*	**–**	96
Dr Sarah S T Liao in the capacity of Secretary for the Environment, Transport and Works	**110**	110
Mr Vincent W S Lo	**110**	110
Mr Frederick S H Ma in the capacity of Secretary for Financial Services and the Treasury	**110**	110
Mr L S Ng**	**110**	14
Mr Patrick B Paul	**110**	110
The Honourable Abraham L H Shek***	**110**	101
Mr Victor H W So#	**–**	9
Mr M Y Wan	**110**	110
Mr Patrick S C Wang##	**–**	9
Professor Richard Y C Wong###	**110**	101
	1,100	1,100

* *Mr Vincent H C Cheng resigned on 15 November 2004.*
** *Mr L S Ng was appointed on 16 November 2004.*
*** *The Honourable Abraham L H Shek was appointed on 1 February 2004.*
# *Mr Victor H W So resigned on 31 January 2004.*
Mr Patrick S C Wang resigned on 31 January 2004.
Professor Richard Y C Wong was appointed on 1 February 2004.

6 Operating profit before depreciation *(continued)*

(c) Emoluments of the Chief Executive Officer and Executive Directors who are not Members of the Managing Board include salaries, retirement benefit scheme contributions, allowances, benefits-in-kind and accruals for gratuities and annual leave entitlements. Details are shown below:

	2005 $ million				2004 $ million			
	Base pay, allowances, gratuities and benefits-in-kind	**Contribution to retirement benefit scheme**	**Variable⁜ remuneration**	**Total**	Base pay, allowances, gratuities and benefits-in-kind	Contribution to retirement benefit scheme	Variable remuneration	Total
Mr Samuel M H Lai* (Acting Chief Executive Officer)	**3.58**	**0.38**	**0.95**	**4.91**	4.51	0.38	0.51	5.40
Mr K K Lee* (Senior Director-Capital Projects)	**3.05**	**0.32**	**0.79**	**4.16**	3.52	0.31	0.40	4.23
Mr Y T Li* (Senior Director-Transport)	**3.11**	**0.28**	**0.71**	**4.10**	3.63	0.28	0.37	4.28
Mr Ian M Thoms@@ (Director-West Rail)	**1.96**	**0.01**	**–**	**1.97**	3.48	0.01	0.39	3.88
Mr Daniel C Lam* (Director-Property)	**3.25**	**0.01**	**0.82**	**4.08**	3.71	0.01	0.41	4.13
Mr Lawrence C P Li** (Director-Finance)	**2.18**	**0.21**	**0.39**	**2.78**	2.59	0.21	–	2.80
Mrs Mimi Cunningham*@ (Director-Human Resource)	**3.03**	**0.01**	**0.76**	**3.80**	2.17	0.01	0.38	2.56
Mr Jonathan H G Yu# (Director-Operations)	**–**	**–**	**–**	**–**	5.81	0.31	–	6.12
Mr Kenneth K S Leung## (Director-New Railway Projects)	**–**	**–**	**–**	**–**	2.03	–	–	2.03
	20.16	**1.22**	**4.42**	**25.80**	31.45	1.52	2.46	35.43

* *With effect from 1 July 2004, a portion of total remuneration was converted to variable remuneration related to performance.*
** *With effect from 1 January 2005, a portion of total remuneration was converted to variable remuneration related to performance.*
@ *Mrs Mimi Cunningham assumed her post with effect from May 2004.*
@@ *Mr Ian M Thoms retired on 1 July 2005.*
# *Mr Jonathan H G Yu left the Corporation on 3 January 2005.*
Mr Kenneth K S Leung retired on 1 July 2004.
⁜ *Variable remuneration is determined by the overall performance of the Corporation and that of the individual concerned. Participants in the scheme contribute a fixed percentage of their remuneration to a pool, to which is added a further contribution by the Corporation if performance exceeds the pre-determined targets. In 2005 the pre-determined targets were exceeded and the Corporation added $1 million to the pool. However, participants unanimously decided, on their own initiative, to retain only that portion representing their personal contributions and requested the Managing Board to reallocate the additional contribution of $1 million to all staff of the Corporation. The variable remuneration shown above represents only the actual amount contributed by and payable to individual participants.*

The above includes the remuneration of the five highest paid employees of the Corporation.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

7 Depreciation

	2005 $ million	2004 Restated $ million
Depreciation		
– assets leased out under operating leases	**32**	16
– other assets	**2,111**	1,559
– depreciation charge capitalised	**(3)**	(6)
	2,140	1,569

8 Interest and finance income/expenses

(a) Interest and finance income

	2005 $ million	2004 $ million
Interest income from deposits with banks	**128**	48
Interest income from investments	**60**	166
Interest income from loans to third party	**51**	53
Interest income from loan to non-controlled subsidiary	**266**	241
Interest income from non-derivative financial assets	**505**	508
Realised gains arising from derivative financial instruments	**85**	197
Exchange gains (net)	**33**	15
	623	720
Less: Amount capitalised*	**(98)**	(276)
	525	444

* *Interest income capitalised was earned at average interest rates ranging between 2.26% (2004: 1.37%) and 4.20% (2004: 2.54%) per annum.*

(b) Interest and finance expenses

	2005 $ million	2004 $ million
Interest expense on lease payable	**50**	52
Interest expenses on other loans	**1,394**	1,384
Finance expenses	**18**	20
Interest and finance expenses on non-derivative financial liabilities	**1,462**	1,456
Realised losses arising from derivative financial instruments	**106**	102
Realised losses on redemption and disposal of investments (including a deficit of $29 million transferred from the investments revaluation reserve (2004: $39 million))	**35**	67
	1,603	1,625
Less: Amount capitalised#	**(780)**	(1,140)
	823	485

Interest expenses capitalised were charged at average interest rates ranging between 6.83% (2004: 6.02%) and 7.54% (2004: 6.88%) per annum.

9 Gains on changes in fair value of derivative financial instruments and hedged borrowings

	2005 $ million	2004 $ million
Net gain arising from derivative financial instruments	**227**	–
Net gain arising from hedged interest-bearing borrowings	**173**	–
	400	–

10 Income tax

(a) Income tax in the consolidated income statement represents:

	2005 $ million	2004 Restated $ million
Current tax		
– Provision for Hong Kong profits tax at 17.5% of the estimated assessable profits for the year	**1**	1
Deferred tax		
– Origination and reversal of temporary differences	**68**	99
	69	100

The provision for Hong Kong profits tax is all in respect of the estimated assessable profits for the year of the subsidiaries of the Corporation. The Corporation sustained a loss for tax purposes during the year and has accumulated tax losses carried forward of approximately $9,700 million at 31 December 2005 (2004: approximately $7,100 million) which are available to set off against future assessable profits. The tax losses do not expire under current tax legislation.

(b) Reconciliation between tax expense and accounting profit at applicable tax rates:

	2005 $ million	2004 Restated $ million
Profit before taxation	**386**	613
Tax on accounting profit before taxation at 17.5%	**67**	107
Tax effect of non-deductible expenses	**33**	30
Tax effect of non-taxable revenue	**(31)**	(37)
Actual tax expense	**69**	100

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

10 Income tax *(continued)*

(c) Current tax in the balance sheet represents:

	Group		Corporation	
	2005	2004	**2005**	2004
	$ million	$ million	**$ million**	$ million
Provision for Hong Kong profits tax for the year	**1**	1	**–**	–
Provisional profits tax paid	**(1)**	(1)	**–**	–
	–	–	**–**	–

(d) Deferred tax assets and liabilities of the Group and the Corporation recognised:

The components of deferred tax (assets)/liabilities of the Group and the Corporation recognised in the Group's and the Corporation's balance sheet and the movements during the year are as follows:

	Deferred tax (assets)/liabilities			
	Future benefit of tax losses $ million	Depreciation allowances in excess of the related depreciation $ million	Revaluation of investment properties $ million	Total $ million
At 1 January 2004				
– as previously reported	(665)	3,796	–	3,131
– prior period adjustment arising from change in accounting policy	–	–	21	21
– as restated	(665)	3,796	21	3,152
Charged/(credited) to the income statement				
– as previously reported	(585)	666	–	81
– prior period adjustment arising from change in accounting policy	–	(8)	26	18
– as restated	(585)	658	26	99
At 31 December 2004	(1,250)	4,454	47	3,251
At 1 January 2005				
– as restated, before opening balance adjustments	**(1,250)**	**4,454**	**47**	**3,251**
– opening balance adjustments arising from changes in accounting policies	**(121)**	**–**	**–**	**(121)**
– as restated, after opening balance adjustments	**(1,371)**	**4,454**	**47**	**3,130**
Charged/(credited) to the income statement	**(336)**	**374**	**30**	**68**
At 31 December 2005	**(1,707)**	**4,828**	**77**	**3,198**

The deferred tax assets and liabilities as at 31 December 2005 are expected to be recovered or settled after 12 months.

11 Profit for the year wholly attributable to the sole shareholder of the Corporation

Of the consolidated profit for the year amounting to $317 million (2004: $513 million as restated), $336 million (2004: $502 million as restated) has been dealt with in the financial statements of the Corporation.

12 Proposed dividend

(a) Dividend payable to the sole shareholder of the Corporation attributable to the year:

	2005 **$ million**	2004 $ million
Final dividend proposed after the balance sheet date of nil per share (2004: $439.67 per share)	**–**	172

The final dividend proposed after the balance sheet date last year was not recognised as a liability at the balance sheet date, but was included in the balance sheet as a separate component of equity.

(b) Dividend payable to the sole shareholder of the Corporation attributable to the previous financial year, approved and paid during the year:

	2005 **$ million**	2004 $ million
Final dividend in respect of the previous financial year, approved and paid during the year, of $439.67 per share (2004: $1,584.87 per share)	**172**	620

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

13 Segmental reporting

Business segment information is chosen as the primary reporting format because this is more relevant to the Group's internal financial reporting. According to HKAS 14, a business segment is a distinguishable component of an enterprise that is engaged for providing an individual product or service and is subject to risks and returns different from other business segments. In determining the nature of risks and returns, HKAS 14 states that an enterprise's internal organisational and management structure and its system of internal financial reporting form the basis for identifying the predominant source and nature of risks and returns facing the enterprise.

No geographical segment information is shown as virtually all of the turnover and operating profit is derived from activities in Hong Kong.

2005

Operating results

	Transport services segment $ million	Property segment $ million	Consolidated total $ million
Revenue	**4,612**	**771**	**5,383**
Operating costs before depreciation	**(2,763)**	**(154)**	**(2,917)**
Inter-segment charges[1]	**38**	**(38)**	**–**
Result before depreciation and valuation gains on investment properties	**1,887**	**579**	**2,466**
Depreciation	**(2,091)**	**(29)**	**(2,120)**
Valuation gains on investment properties	**–**	**171**	**171**
Result	**(204)**	**721**	**517**
Unallocated corporate expenses and depreciation			**(248)**
Operating profit before interest and finance income/expenses and after valuation gains on investment properties			**269**
Interest and finance income			**525**
Interest and finance expenses			**(823)**
Gains on changes in fair value of derivative financial instruments and hedged borrowings			**400**
Share of profit of associate			**15**
Income tax			**(69)**
Profit after taxation			**317**

(1) *Inter-segment charges represent cost recoveries from other segments for services rendered.*

13 Segmental reporting *(continued)*

Assets and liabilities

	Transport services segment $ million	Property segment $ million	Consolidated total $ million
Assets	65,509	1,971	67,480
Properties under development	–	1,537	1,537
Interest in associate	–	–	72
Railways under construction@	–	–	11,165
Unallocated assets#	–	–	9,498
	65,509	3,508	89,752
Liabilities	645	671	1,316
Deferred income	350	191	541
Unallocated liabilities*	–	–	28,242
	995	862	30,099

@ *Comprising construction and land costs of Lok Ma Chau and Kowloon Southern Link ($9,955 million) and planning and design costs of Shatin to Central Link, Express Rail Link and Northern Link ($1,210 million).*

Comprising corporate assets and construction in progress for corporate office ($341 million), derivative financial assets ($129 million), investments ($449 million), loans to third party ($684 million), loan to non-controlled subsidiary ($3,863 million), interest and other receivables ($638 million) and cash and cash equivalents ($3,394 million).

* *Comprising interest-bearing borrowings ($19,474 million), accrued charges and provisions for capital projects ($2,912 million), lease payable ($684 million), interest and other payables ($1,613 million), deferred tax liabilities ($3,198 million) and derivative financial liabilities ($361 million).*

Other information

	Transport services segment $ million	Property segment $ million	Consolidated total $ million
Capital expenditure:			
– Operational railways	1,165	127	1,292
– Railways under construction	–	–	2,535
– Unallocated capital expenditure	–	–	8
	1,165	127	3,835

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

13 Segmental reporting *(continued)*

2004 restated
Operating results

	Transport services segment $ million	Property segment $ million	Consolidated total $ million
Revenue	4,281	695	4,976
Operating costs before depreciation	(2,558)	(129)	(2,687)
Inter-segment charges[1]	35	(35)	–
Result before depreciation and valuation gains on investment properties	1,758	531	2,289
Depreciation	(1,519)	(28)	(1,547)
Valuation gains on investment properties	–	148	148
Result	239	651	890
Unallocated corporate expenses and depreciation			(251)
Operating profit before interest and finance income/expenses and after valuation gains on investment properties			639
Interest and finance income			444
Interest and finance expenses			(485)
Share of profit of associate			15
Income tax			(100)
Profit after taxation			513

(1) *Inter-segment charges represent cost recoveries from other segments for services rendered.*

13 Segmental reporting *(continued)*

2004 restated
Assets and liabilities

	Transport services segment $ million	Property segment $ million	Consolidated total $ million
Assets	66,530	1,682	68,212
Properties under development	–	1,892	1,892
Interest in associate	–	–	57
Railways under construction[@]	–	–	7,981
Unallocated assets[#]	–	–	13,244
	66,530	3,574	91,386
Liabilities	367	636	1,003
Deferred income	584	124	708
Unallocated liabilities*	–	–	29,613
	951	760	31,324

@ *Comprising construction and land costs of Lok Ma Chau ($6,519 million) and planning and design costs of Shatin to Central Link, Kowloon Southern Link and Northern Link ($1,462 million).*

Comprising corporate assets and construction in progress for corporate office ($409 million), investments ($4,323 million), loans to third party ($733 million), loan to non-controlled subsidiary ($3,576 million), interest and other receivables ($672 million) and cash and cash equivalents ($3,531 million).

* *Comprising interest-bearing borrowings ($19,748 million), accrued charges and provisions for capital projects ($3,875 million), lease payable ($717 million), interest and other payables ($2,022 million) and deferred tax liabilities ($3,251 million).*

Other information

	Transport services segment $ million	Property segment $ million	Consolidated total $ million
Capital expenditure			
– Operational railways	6,678	61	6,739
– Railways under construction	–	–	2,278
– Unallocated capital expenditure	–	–	8
	6,678	61	9,025

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

14 Fixed assets and interest in leasehold land held for own use under operating leases

(a) The Group

	Investment properties $ million	Tunnels, bridges, roads and permanent way $ million	Buildings $ million	Rolling stock $ million	Other equipment $ million	Total fixed assets $ million	Interest in leasehold land held for own use $ million
Cost or valuation:							
At 1 January 2004 (restated)	878	13,344	20,297	8,055	8,997	51,571	7,011
Reclassification	–	2,121	233	–	(28)	2,326	(2,326)
Transfer from construction in progress	–	4,118	7,172	1,219	2,123	14,632	218
Additions	–	338	1,159	8	87	1,592	1,010
Disposals	–	(7)	(3)	–	(90)	(100)	–
Fair value adjustment	148	–	–	–	–	148	–
At 31 December 2004 (restated)	1,026	19,914	28,858	9,282	11,089	70,169	5,913
At 1 January 2005 (restated)	**1,026**	**19,914**	**28,858**	**9,282**	**11,089**	**70,169**	**5,913**
Transfer from construction in progress	**–**	**43**	**282**	**(4)**	**314**	**635**	**–**
Additions	**–**	**284**	**313**	**(7)**	**37**	**627**	**72**
Disposals	**(26)**	**(16)**	**(6)**	**–**	**(68)**	**(116)**	**–**
Fair value adjustment	**171**	**–**	**–**	**–**	**–**	**171**	**–**
At 31 December 2005	**1,171**	**20,225**	**29,447**	**9,271**	**11,372**	**71,486**	**5,985**
Accumulated depreciation and amortisation:							
At 1 January 2004 (restated)	–	183	970	2,005	3,465	6,623	102
Reclassification	–	(1)	–	–	(7)	(8)	8
Charge for the year	–	202	448	239	686	1,575	112
Written back on disposals	–	–	(1)	–	(75)	(76)	–
At 31 December 2004 (restated)	–	384	1,417	2,244	4,069	8,114	222
At 1 January 2005 (restated)	**–**	**384**	**1,417**	**2,244**	**4,069**	**8,114**	**222**
Charge for the year	**–**	**464**	**600**	**275**	**804**	**2,143**	**118**
Written back on disposals	**–**	**(1)**	**(2)**	**–**	**(66)**	**(69)**	**–**
At 31 December 2005	**–**	**847**	**2,015**	**2,519**	**4,807**	**10,188**	**340**
Carrying amounts:							
At 31 December 2005	**1,171**	**19,378**	**27,432**	**6,752**	**6,565**	**61,298**	**5,645**
At 31 December 2004 (restated)	1,026	19,530	27,441	7,038	7,020	62,055	5,691

14 Fixed assets and interest in leasehold land held for own use under operating leases *(continued)*

(b) The Corporation

	Investment properties $ million	Tunnels, bridges, roads and permanent way $ million	Buildings $ million	Rolling stock $ million	Other equipment $ million	Total fixed assets $ million	Interest in leasehold land held for own use $ million
Cost or valuation:							
At 1 January 2004 (restated)	878	13,344	20,297	8,055	8,960	51,534	7,011
Reclassification	–	2,121	233	–	(28)	2,326	(2,326)
Transfer from construction in progress	–	4,118	7,172	1,219	2,106	14,615	218
Additions	–	338	1,159	8	87	1,592	1,010
Disposals	–	(7)	(3)	–	(90)	(100)	–
Fair value adjustment	148	–	–	–	–	148	–
At 31 December 2004 (restated)	1,026	19,914	28,858	9,282	11,035	70,115	5,913
At 1 January 2005 (restated)	**1,026**	**19,914**	**28,858**	**9,282**	**11,035**	**70,115**	**5,913**
Transfer from construction in progress	**–**	**43**	**282**	**(4)**	**317**	**638**	**–**
Additions	**–**	**284**	**313**	**(7)**	**37**	**627**	**72**
Disposals	**(26)**	**(16)**	**(6)**	**–**	**(68)**	**(116)**	**–**
Fair value adjustment	**171**	**–**	**–**	**–**	**–**	**171**	**–**
At 31 December 2005	**1,171**	**20,225**	**29,447**	**9,271**	**11,321**	**71,435**	**5,985**
Accumulated depreciation and amortisation:							
At 1 January 2004 (restated)	–	183	970	2,005	3,465	6,623	102
Reclassification	–	(1)	–	–	(7)	(8)	8
Charge for the year	–	202	448	239	682	1,571	112
Written back on disposals	–	–	(1)	–	(75)	(76)	–
At 31 December 2004 (restated)	–	384	1,417	2,244	4,065	8,110	222
At 1 January 2005 (restated)	**–**	**384**	**1,417**	**2,244**	**4,065**	**8,110**	**222**
Charge for the year	**–**	**464**	**600**	**275**	**798**	**2,137**	**118**
Written back on disposals	**–**	**(1)**	**(2)**	**–**	**(66)**	**(69)**	**–**
At 31 December 2005	**–**	**847**	**2,015**	**2,519**	**4,797**	**10,178**	**340**
Carrying amounts:							
At 31 December 2005	**1,171**	**19,378**	**27,432**	**6,752**	**6,524**	**61,257**	**5,645**
At 31 December 2004 (restated)	1,026	19,530	27,441	7,038	6,970	62,005	5,691

(c) Permanent way principally comprises the costs of rail tracks, sleepers, track base and ballast.

(d) Other equipment comprises lifts and escalators, telecommunication and signalling systems, machinery, furniture and fixtures, motor vehicles and computer and office equipment.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

14 Fixed assets and interest in leasehold land held for own use under operating leases *(continued)*

(e) The Group and the Corporation lease out investment properties and certain properties which are either used in or ancillary to the Group's and Corporation's rail business, under operating leases. The leases typically run for an initial period of two to five years, with an option to renew the lease after that date at which time all terms are re-negotiated. The leases may include additional rentals based on sales revenue of the tenants in excess of the basic rentals.

(f) The fair values of the Group's and Corporation's investment properties, held in Hong Kong under long-term leases, at 31 December 2005 were remeasured on the basis of capitalisation of the net income with due allowance for reversionary income potential. The valuations were carried out by an independent firm of surveyors, which has among its staff fellow and associate members of the Hong Kong Institute of Surveyors with recent experience in the location and category of property being valued. The fair value gain of $171 million (2004: $148 million) has been transferred to the income statement.

(g) Other than investment properties, included in fixed assets are assets leased out under operating leases with gross carrying amounts and related accumulated depreciation charges as follows:

	Gross carrying amount 2005 $ million	**Related accumulated depreciation 2005 $ million**	Gross carrying amount 2004 $ million	Related accumulated depreciation 2004 $ million
Goods yard at Hung Hom Bay	**85**	**11**	85	9
Hung Hom Station Car Park	**56**	**24**	55	22
Offices at Hung Hom Station	**23**	**6**	21	6
Offices at Hung Hom freight building	**6**	**1**	6	1
Citylink Plaza at Sha Tin Station	**144**	**63**	104	60
Goods yard at Mongkok Station	**45**	**7**	45	6
Shops at stations	**764**	**81**	672	59
Mobile phone coverage system	**84**	**43**	87	37
Trackside Villas	**30**	**7**	19	4
	1,237	**243**	1,094	204

Although these properties are leased to tenants, they are not held for their investment potential. These assets are situated on railway land vested in the Corporation by the Government for railway purposes and are either used in or are ancillary to the Group's railway business. They are an integral part of the railway network and cannot be sold separately without the agreement of the Government. Accordingly, these assets are not classified as investment properties.

14 Fixed assets and interest in leasehold land held for own use under operating leases *(continued)*

(h) The minimum total future amounts received by the Group and Corporation under non-cancellable operating leases are expected to be received as follows:

	2005 **$ million**	2004 $ million
Within one year	**663**	659
After one year but within five years	**704**	914
After five years	**15**	41
	1,382	1,614

(i) The Group and Corporation have entered into a number of individually structured transactions or arrangements with unrelated parties to lease out and lease back assets which include rolling stock, signalling equipment, revenue collection equipment and railway infrastructure. Under each arrangement, the Group and Corporation have leased the assets to an overseas investor, who has prepaid all the rentals in relation to a lease agreement. Simultaneously, the Group and Corporation have leased the assets back from the overseas investor and will pay the rentals on a semi-annual or annual basis in accordance with a pre-determined payment schedule. The Group and Corporation have an option to purchase the overseas investor's leasehold interest in the assets at a pre-determined date for a fixed or agreed amount and it is the intention of the Group and Corporation to exercise such purchase options. The rental prepayments received from the overseas investor have been placed in deposits or invested in debt securities, or loaned to an unrelated party, the repayments of which are expected to be sufficient to meet the Group's and Corporation's rental obligations and the amounts payable for exercising the purchase options under the lease agreements. As long as the Group and Corporation comply with the requirements of the lease agreements, the Group and Corporation will continue to be entitled to quiet enjoyment of and continued possession, use or operation of the assets subject to these arrangements. The arrangements have been entered with investors in the United States and the United Kingdom.

As at 31 December 2005, a portion of the Group's and Corporation's assets (including assets replaced during the lease periods) with a total cost of $11,919 million (2004: $11,819 million) and net book value of $7,579 million (2004: $7,913 million) is covered by nine arrangements. Six arrangements involve rolling stock, with basic lease terms of 15 to 28 years. Two arrangements, one involving signalling equipment and the other involving the revenue collection system, have a basic lease term of 15 years. The remaining arrangement involving railway infrastructure has basic lease terms of between 24 years and 27 years. Since the Group and Corporation retain risks and rewards incidental to ownership of the underlying assets in respect of each arrangement and enjoys substantially the same rights to their use as before the arrangements where entered into, no adjustment has been made to fixed assets. As a result of the nine arrangements, the Group and Corporation has received cash of $13,480 million (2004: $13,480 million) and, assuming exercise of the purchase option in each arrangement, will be obligated to make long-term lease payments over the duration of the relevant leases with a total estimated net present value at the inception of the arrangements of $12,681 million (2004: $12,681 million), the obligations of which are expected to be funded by the proceeds to be generated from existing deposits and investments and the loan repayments from a third party over the relevant lease periods.

The total net amounts of cash received by the Group and Corporation from the arrangements have been recorded as deferred income and are being amortised to the income statement over the applicable lease terms of the arrangements. The total amount of $39 million (2004: $39 million) recognised for the period has been included in the transport services segment in the income statement.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

14 Fixed assets and interest in leasehold land held for own use under operating leases *(continued)*

(j) Included in additions are amounts paid and payable to the Government by the Corporation in respect of the following:

- $18 million (2004: $143 million) for land resumption work on the West Rail, Ma On Shan Rail and Tsim Sha Tsui Extension projects undertaken by the Government on behalf of the Corporation and for lease of land required for construction sites.

- nil (2004: $958 million) for compensation in respect of resumed land in relation to the West Rail project paid and payable by the Government on behalf of the Corporation. The Corporation is obligated to reimburse such sums to the Government.

- $50 million (2004: $150 million) for land premiums payable by the Corporation in respect of the East Rail Extensions project.

(k) In compliance with HKAS 16 which requires an annual review of the estimated useful lives of fixed assets, an extensive review was undertaken by in-house engineers of the estimated useful lives of all major fixed asset categories during the year. With effect from 1 January 2005, the estimated useful lives of certain assets were revised after taking into consideration the actual condition of the assets and planned asset replacement programmes. Management considers that the revised useful lives better reflect the period over which the related assets will be used in the operations of the Group. These changes in accounting estimates have been adopted on a prospective basis such that the carrying value of the assets affected will be depreciated over the revised estimated useful lives. Details of the assets affected and the resultant financial effect are as follows:

Asset category	Original useful life (Years)	Revised useful life (Years)	Decrease in depreciation charge for the year $ million
Fitting-out works	10	15	8
Ballast	15	20	3
Fare collection systems	10 to 15	15	17
			28

(l) The carrying value of the Group's and Corporation's interest in leasehold land held in Hong Kong is $5,617 million (2004: $5,663 million) under medium-term leases (less than 50 years) and $28 million (2004: $28 million) under long-term leases (50 years or above).

15 Construction in progress

Construction in progress comprises:

(a) The Group

2005

	Kowloon Southern Link $ million	**East Rail Extensions $ million**	**Other assets $ million**	**Total construction in progress $ million**
Balance as at 1 January 2005	**–**	**6,514#**	**472**	**6,986**
Transfer from deferred expenditure	**875**	**–**	**–**	**875**
Costs incurred during the year	**432**	**2,304**	**449**	**3,185**
Transfer to fixed assets or leasehold land	**–**	**(170)**	**(465)**	**(635)**
Balance as at 31 December 2005	**1,307**	**8,648**	**456**	**10,411**

After deduction of an opening balance adjustment of $5 million upon adoption of HKAS 32 and HKAS 39.

2004

	East Rail Extensions $ million	Other assets $ million	Total construction in progress $ million
Balance as at 1 January 2004	14,091	1,010	15,101
Costs incurred during the year	6,158	582	6,740
Transfer to fixed assets or leasehold land	(13,730)	(1,120)	(14,850)
Balance as at 31 December 2004	6,519	472	6,991

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

15 Construction in progress *(continued)*

(b) The Corporation

2005

	Kowloon Southern Link $ million	East Rail Extensions $ million	Other assets $ million	Total construction in progress $ million
Balance as at 1 January 2005	–	6,514#	472	6,986
Transfer from deferred expenditure	875	–	–	875
Costs incurred during the year	432	2,304	449	3,185
Transfer from a subsidiary	–	–	3	3
Transfer to fixed assets or leasehold land	–	(170)	(468)	(638)
Balance as at 31 December 2005	1,307	8,648	456	10,411

After deduction of an opening balance adjustment of $5 million upon adoption of HKAS 32 and HKAS 39.

2004

	East Rail Extensions $ million	Other assets $ million	Total construction in progress $ million
Balance as at 1 January 2004	14,091	1,010	15,101
Costs incurred during the year	6,158	582	6,740
Transfer to a subsidiary	–	(17)	(17)
Transfer to fixed assets or leasehold land	(13,730)	(1,103)	(14,833)
Balance as at 31 December 2004	6,519	472	6,991

(c) As at 31 December 2005, land resumption costs and other costs totalling approximately $612 million (2004: $602 million) and $24 million (2004: $7 million) directly associated with the acquisition of leasehold land for the construction of the East Rail Extensions and the Kowloon Southern Link respectively are included in the balance of construction in progress. These costs will be transferred to interest in leasehold land when the land is vested in the Corporation by the Government, at which time the costs will begin to be amortised in accordance with relevant policies.

(d) Included in costs incurred during the year are amounts paid and payable to the Government by the Corporation in respect of the following:

– $13 million (2004: $42 million) for the lease of land required for construction sites for the East Rail Extensions and Kowloon Southern Link projects. The land does not have a measurable value as it cannot be assigned and can only be used by the Corporation and/or its contractors.

– $9 million (2004: $195 million) for land resumption work undertaken by the Government and compensation in respect of resumed land paid and payable by the Government on behalf of the Corporation in respect of the East Rail Extensions and Kowloon Southern Link projects. The Corporation is obligated to reimburse such sums to the Government.

15 Construction in progress *(continued)*

(e) The costs incurred during the year are arrived at after crediting of $23 million (2004: $75 million) on-cost recovery from the Government for certain essential public infrastructure works and other works along the railways undertaken by the Corporation on its behalf pursuant to the entrustment agreements in respect of such entrustment works and from the subsidiary, West Rail Property Development Limited, for property development along the West Rail, Phase I route as governed by the Shareholding Agreement between the Corporation and the Government (see note 21).

16 Deferred expenditure

Deferred expenditure comprises:

2005

	Shatin to Central Link $ million	**Kowloon Southern Link $ million**	**Express Rail Link/ Northern Link $ million**	**Total deferred expenditure $ million**
Balance as at 1 January 2005	**1,178#**	**279**	**4**	**1,461**
Expenditure during the year	**10**	**569**	**18**	**597**
Interest and finance income/expenses	**–**	**27**	**–**	**27**
Transfer to construction in progress	**–**	**(875)**	**–**	**(875)**
Balance as at 31 December 2005	**1,188**	**–**	**22**	**1,210**

After deduction of an opening balance adjustment of $1 million upon adoption of HKAS 32 and HKAS 39.

2004

	Shatin to Central Link $ million	Kowloon Southern Link $ million	Northern Link $ million	Total deferred expenditure $ million
Balance as at 1 January 2004	731	169	–	900
Expenditure during the year	437	107	4	548
Interest and finance income/expenses	11	3	–	14
Balance as at 31 December 2004	1,179	279	4	1,462

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

16 Deferred expenditure *(continued)*

(a) The planning, design and construction of Shatin to Central Link was suspended in 2005 pending the announcement of a decision by the Government. On 4 March 2005, the Government responded to the Legislative Council Transport Panel that the Government remains committed to the provision of Shatin to Central Link and that the preferred scheme would be made known publicly at the time a decision on the possible merger of the Corporation and MTR Corporation Limited is announced. In response to the Corporation's enquiries, the Government advised on 24 January 2006 that the Government is examining the Shatin to Central Link proposal submitted by the Corporation and the proposal submitted by the Corporation and the MTR Corporation Limited on a possible merger. The Government has also confirmed that there is no plan to abort the project. Against this background, management considers that the project will proceed albeit that the implementation timetable has yet to be agreed. Therefore, the costs incurred to date on the project have been retained in the deferred expenditure, although interest capitalisation has ceased until the project is resumed.

(b) As at 31 December 2005, land related costs totalling approximately $6 million (2004: $8 million) directly associated with the acquisition of leasehold land for the purpose of the Shatin to Central Link are included in the balance of deferred expenditure. These costs will be transferred to interest in leasehold land when the land is vested in the Corporation by the Government, at which time the costs begin to be amortised in accordance with the relevant policies.

(c) Expenditure incurred during the year includes $18 million (2004: $8 million) paid and payable to the Government by the Corporation for land related work on the Shatin to Central Link and Kowloon Southern Link projects undertaken by the Government on behalf of the Corporation.

17 Properties under development

	2005 $ million	2004 $ million
Balance as at 1 January	**1,892**	1,448
Expenditure incurred during the year	**35**	444
Amounts recovered during the year	**(390)**	–
Balance as at 31 December	**1,537**	1,892

The balance of expenditure on properties under development is mainly related to the property enabling works for development sites at Che Kung Temple Station, Tai Wai Maintenance Centre, Tai Wai Station and Wu Kai Sha Station. During the year, the Corporation awarded a joint venture tender for property development at Wu Kai Sha Station and recovered from the joint venture developer the expenditure incurred to date for site development. The other development projects will be put out to tender from 2006 onwards in accordance with the master tender programme as agreed with the Government.

Included in the amounts recovered is a cost recovery of $88 million (2004: nil) from the Government in respect of the public transport interchange and property development enabling works.

18 Investments in subsidiaries

	Corporation 2005 $ million	Corporation 2004 $ million
Unlisted shares, at cost	–	–

Details of the subsidiaries listed by principal activities are as follows:

Name of company	Place of incorporation and operation	Number of issued and fully paid ordinary shares	Par value of shares	Percentage of shares held by the Corporation	Percentage of shares held by a subsidiary
Property Management					
Manlai Court Property Management Company Limited	Hong Kong	25,500 'A' 24,500 'B'	$1 $1	100% Nil	Nil Nil
Sun Tuen Mun Centre Management Company Limited	Hong Kong	25,000 'A' 25,000 'B'	$1 $1	100% 100%	Nil Nil
Royal Ascot Management Company Limited	Hong Kong	25,000 'A' 25,000 'B'	$1 $1	100% 100%	Nil Nil
Hanford Garden Property Management Company Limited	Hong Kong	10,000	$1	100%	Nil
Pierhead Garden Management Company Limited	Hong Kong	25,000 'A' 25,000 'B'	$1 $1	100% Nil	Nil 100%
The Metropolis Management Company Limited	Hong Kong	25,500 'A' 24,500 'B'	$1 $1	100% Nil	Nil Nil
Capital System Limited	Hong Kong	5,000	$1	100%	Nil
Asset Leasing					
Buoyant Asset Limited	Hong Kong	100	$10	100%	Nil
Advanced Asset Limited	Hong Kong	100	$10	100%	Nil
Quality Asset Limited	Hong Kong	100	$10	100%	Nil
Kasey Asset Limited	Hong Kong	100	$10	100%	Nil
Circuit Asset Limited	Hong Kong	100	$10	100%	Nil
Shining Asset Limited	Hong Kong	100	$10	100%	Nil
Fluent Asset Limited	Hong Kong	100	$10	100%	Nil
Kudos Asset Limited	Hong Kong	100	$10	100%	Nil
Unique Asset Limited	Hong Kong	100	$10	100%	Nil

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

18 Investments in subsidiaries *(continued)*

Name of company	Place of incorporation and operation	Number of issued and fully paid ordinary shares	Par value of shares	Percentage of shares held by the Corporation	Percentage of shares held by a subsidiary
Bowman Asset Limited	Cayman Islands	1,000	US$1	100%	Nil
Statesman Asset Limited	Cayman Islands	1,000	US$1	100%	Nil
Interwind Asset Limited	Hong Kong	100	$10	100%	Nil
V-Connect Limited	Hong Kong	100	$10	100%	Nil
Property Development (non-controlled subsidiaries)					
West Rail Property Development Limited, and its 13 wholly owned subsidiaries*	Hong Kong	51 'A' 49 'B'	$10 $10	100% Nil	Nil Nil

* *These subsidiaries are held by the Corporation for the sole purpose of developing commercial or residential property along the West Rail, Phase I route on behalf of the Government. Their financial statements are excluded from consolidation as the Corporation has no effective control over nor beneficial interests in the net assets of these subsidiaries, other than the amount of capital provided.*

A summary of consolidated financial information of WRPDL and its subsidiaries based on the management accounts of these companies as of 31 December is as follows:

	2005 $ million	2004 $ million
Assets	**3,861**	3,574
Liabilities	**3,863**	3,576
Equity	**(2)**	(2)
Turnover	**–**	–
Profit/(loss) after tax for the year	**–**	–

19 Interest in associate

The interest in associate is as follows:

	Group		**Corporation**	
	2005 $ million	2004 $ million	**2005 $ million**	2004 $ million
Unlisted shares, at cost	**–**	–	**9**	9
Share of net assets	**39**	57	**–**	–
Loan to associate	**33**	–	**33**	–
	72	57	**42**	9

19 Interest in associate *(continued)*

Details of the associate, which is incorporated and operates in Hong Kong, are as follows:

Name of company	Number of issued and fully paid shares	Par value of shares	Percentage of shares held
Octopus Cards Limited (sold on 21 October 2005)	42,000,000	$1	22.1%
Octopus Holdings Limited (acquired on 21 October 2005)	42,000,000 ordinary	$1	22.1%

On 17 January 2001, the Corporation entered into a service agreement with Octopus Cards Limited in order to formalise the existing arrangements for the provision of services to each other relating to the use of Octopus cards. Under the service agreement, the Corporation will continue to accept the use of Octopus cards for payment of fares and to provide add-value, refund and other ancillary services to Octopus Cards Limited.

On 21 October 2005, the Corporation and the other shareholders of Octopus Cards Limited entered into a number of agreements to adjust the arrangements relating to Octopus Cards Limited, in order to transfer the non-payment businesses of Octopus Cards Limited to a number of new and separate subsidiaries independent of the payment business of Octopus Cards Limited. To effect these adjustments, a new holding company, Octopus Holdings Limited, was incorporated. The shareholders of Octopus Cards Limited divested themselves of all their shares in Octopus Cards Limited to Octopus Holdings Limited in consideration for the issue to them of new shares in Octopus Holdings Limited.

As a consequence, the shareholding structure of Octopus Holdings Limited is the same as that of Octopus Cards Limited immediately before such sale and purchase of shares in Octopus Cards Limited. Octopus Cards Limited became a wholly owned subsidiary of Octopus Holdings Limited after the restructuring. The service agreement with Octopus Cards Limited entered into on 17 January 2001 remains in force.

Immediately after completion of the sale and purchase of shares in Octopus Cards Limited, the shareholders of Octopus Holdings Limited made a loan in aggregate amounting to $150 million to Octopus Holdings Limited, pursuant to a Subordinated Loan Agreement, with each shareholder lending an amount in proportion to its shareholding in Octopus Holdings Limited. The loan to associate from the Corporation bears interest at 5.5% per annum. It is unsecured and repayable in whole or in part at any time before 20 October 2010.

During the year, the Group made payments to Octopus Cards Limited, amounting to $36 million (2004: $33 million) in respect of fees for the use of the Octopus cards system. These payments were based on the fare revenue generated from Octopus cards. No other charges were made or incurred by the Group in respect of the administration of the Octopus cards system. The Group received $7 million (2004: $8 million) from Octopus Cards Limited in respect of ticket loading agent fees for providing add-value amounts on Octopus cards and handling fees for issuing new cards and handling refunds for returned cards.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

19 Interest in associate *(continued)*

A summary of financial information of the associate based on the consolidated management accounts of Octopus Holdings Limited as of 31 December and of Octopus Cards Limited as of 31 December 2004 is as follows:

	2005 $ million 100%	**2005 $ million Group's effective interest (22.1%)**	2004 $ million 100%	2004 $ million Group's effective interest (22.1%)
Assets	**1,833**	**405**	1,554	343
Liabilities	**1,653**	**365**	1,443	319
Equity	**180**	**40**	111	24
Turnover	**354**	**78**	317	70
Profit after tax for the year	**69**	**15**	69	15

20 Loans to third party

Under one of the lease arrangements entered into by the Group and the Corporation, the future lease payments are funded by the interest earned on the loans to third party and the repayment of the loans from third party to the Group and the Corporation. The interest rates on the loans to third party are predetermined.

The loans to third party are expected to be offset with lease payable within one year upon finalisation of termination provisions with the investor of the lease arrangement.

	Group		**Corporation**	
	2005 $ million	2004 $ million	**2005 $ million**	2004 $ million
Within one year	**684**	31	**–**	–
After one year	**–**	702	**–**	16
	684	733	**–**	16

21 Loan to non-controlled subsidiary

On 24 February 2000, the Corporation and the Government entered into a shareholding agreement (the "Shareholding Agreement") for the formation of a sub-group of the Corporation under an intermediate holding company, West Rail Property Development Limited ("WRPDL"), to undertake all property developments along the West Rail, Phase I route. The issued share capital of WRPDL comprises 51 ordinary "A" shares and 49 ordinary "B" shares, which are held by the Corporation and the Government respectively. The holders of ordinary "A" shares are not entitled to any distribution by WRPDL other than a return of capital, and the holders of ordinary "B" shares are entitled to all dividends declared by WRPDL and a return of capital. In other words, the Corporation is not entitled to any earnings distribution, nor is it required to ultimately fund any losses which may be sustained by WRPDL and its subsidiaries.

21 Loan to non-controlled subsidiary *(continued)*

All costs incurred or to be incurred in relation to the West Rail property developments are to be funded by loans from the Corporation to WRPDL bearing interest at an annual rate of 1% over the Corporation's average cost of funds in the preceding year. To the extent that WRPDL may be unable to repay the loan, the Government shall seek the necessary authority to reimburse costs incurred by the Corporation. The Government has also undertaken to indemnify the Corporation against all liabilities properly incurred by the Corporation in relation to such property developments.

Subsidiaries of WRPDL have been formed to handle the property developments along the West Rail, Phase I route. The Government will receive the profits less losses from the developments whereby the Corporation will recover the on-costs for the handling of the property developments along the route.

The loan to non-controlled subsidiary is expected to be recovered as follows:

	2005 $ million	2004 $ million
Within one year	**1,202**	–
After one year	**2,661**	3,576
	3,863	3,576

22 Investments

(a) Investments comprise:

	2005 $ million	2004 $ million
Available-for-sale debt securities		
– Listed outside Hong Kong	**31**	578
– Unlisted	**369**	1,645
Interest-bearing deposits temporarily placed with the custodian bank	**49**	2,100
Total fair value of investments	**449**	4,323
Total market value of listed investments	**31**	578

(b) Investments are expected to mature as follows:

	2005 $ million	2004 $ million
Within one year	**449**	3,960
After one year	**–**	363
	449	4,323

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

23 Stores and spares

Stores and spares are expected to be consumed as follows:

	2005 $ million	2004 $ million
Within one year	**159**	164
After one year	**184**	155
	343	319

24 Interest and other receivables

(a) Interest and other receivables comprise:

	Group		**Corporation**	
	2005 $ million	2004 $ million	**2005 $ million**	2004 $ million
Interest receivable	**42**	49	**26**	32
Amounts due from subsidiaries	**–**	–	**10**	23
Amount due from the Government	**432**	510	**432**	510
Debtors, deposits, prepayments and revenue in arrears	**243**	197	**239**	186
	717	756	**707**	751

The amount due from the Government represents $377 million (2004: $446 million) in respect of certain essential public infrastructure works and other works along the railways undertaken on behalf of the Government pursuant to the respective entrustment agreements with the Government and $55 million (2004: $64 million) for "on-costs" charged to the Government in respect of such entrustment works.

(b) Interest and other receivables are expected to be recovered as follows:

	Group		**Corporation**	
	2005 $ million	2004 $ million	**2005 $ million**	2004 $ million
Within one year	**651**	732	**645**	727
After one year	**66**	24	**62**	24
	717	756	**707**	751

24 Interest and other receivables *(continued)*

(c) Included in interest and other receivables are debtors with the following ageing analysis:

	Group		Corporation	
	2005	2004	**2005**	2004
	$ million	$ million	**$ million**	$ million
Current	**573**	688	**563**	683
Less than one month overdue	**3**	6	**3**	6
One to three months overdue	**3**	17	**3**	17
More than three months overdue	**5**	2	**5**	2
Total debtors	**584**	713	**574**	708
Deposits, prepayments and revenue in arrears	**133**	43	**133**	43
	717	756	**707**	751

Normally, no credit is allowed except for revenue sharing arrangements in which the normal credit period is one month. For the amount due from the Government regarding the entrustment works undertaken by the Corporation on behalf of the Government, the normal credit period is 21 days pursuant to the respective entrustment agreements.

25 Cash and cash equivalents

Cash and cash equivalents comprise:

	Group		Corporation	
	2005	2004	**2005**	2004
	$ million	$ million	**$ million**	$ million
Deposits with banks				
– Within three months to maturity when placed	**1,797**	2,555	**1,673**	2,450
– More than three months to maturity when placed	**1,555**	940	**1,555**	940
Cash at bank and in hand	**42**	36	**42**	36
Cash and cash equivalents in the balance sheets	**3,394**	3,531	**3,270**	3,426
Less: deposits with banks with more than three months to maturity when placed	**(1,555)**	(940)		
Cash and cash equivalents in the consolidated cash flow statement	**1,839**	2,591		

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

26 Interest and other payables

(a) Interest and other payables comprise:

	Group		Corporation	
	2005	2004	**2005**	2004
	$ million	$ million	**$ million**	$ million
Interest payable	**486**	485	**470**	468
Deposits and advances	**1,075**	1,173	**954**	1,085
Creditors, accrued charges and provisions	**1,242**	1,271	**1,236**	1,257
Amounts due to subsidiaries	**–**	–	**4**	1
	2,803	2,929	**2,664**	2,811

Included in creditors, accrued charges and provisions is a provision of $217 million (2004: nil) made for the estimated amount payable by the Corporation upon termination of one of the lease arrangements as referred to in note 14(i) which is subject to mandatory termination upon the occurrence of certain specified events or circumstances in accordance with the related agreements.

(b) Interest and other payables are expected to be settled as follows:

	Group		Corporation	
	2005	2004	**2005**	2004
	$ million	$ million	**$ million**	$ million
Within one year	**2,132**	2,054	**1,993**	1,936
After one year	**671**	875	**671**	875
	2,803	2,929	**2,664**	2,811

(c) Included in interest and other payables are creditors with the following ageing analysis:

	Group		Corporation	
	2005	2004	**2005**	2004
	$ million	$ million	**$ million**	$ million
Due within one month or on demand	**641**	706	**645**	698
Due between one month to three months	**234**	202	**218**	185
Due between three months to six months	**45**	45	**45**	45
Due after six months	**255**	313	**255**	313
Total creditors	**1,175**	1,266	**1,163**	1,241
Deposits and advances	**1,075**	1,173	**954**	1,085
Accrued charges and provisions	**553**	490	**547**	485
	2,803	2,929	**2,664**	2,811

27 Accrued charges and provisions for capital projects

The balance includes accrued charges and provisions for claims related to capital projects. Accrued charges will be settled upon certification of work done. Provisions for claims relate mainly to the West Rail, East Rail Extensions and Kowloon Southern Link projects.

The balance includes an aggregate amount of $1,584 million (2004: $1,511 million) payable to the Government mainly for land premium, resumption and associated costs in relation to the West Rail, East Rail Extensions, Shatin to Central Link and Kowloon Southern Link projects.

During the year, the Corporation made additional provisions for claims and land premium, resumption and associated costs of $646 million and reversed or utilised amounts totalling $1,789 million. As of 31 December 2005, provision for claims and land premium, resumption and associated costs totalled $1,936 million.

Accrued charges and provisions for capital projects are expected to be settled or utilised as follows:

	2005 $ million	2004 $ million
Within one year	**1,814**	3,284
After one year	**1,224**	687
	3,038	3,971

28 Lease payable

The amounts payable by the Group under the lease arrangement are expected to be settled as follows:

	2005 $ million	2004 $ million
Within one year	**684**	31
After one year	**–**	686
	684	717

The lease payable is expected to be offset with the loans to third party within one year upon finalisation of the termination provisions with the investor of the lease arrangement.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

29 Interest-bearing borrowings

(a) Interest-bearing borrowings comprise:

	Carrying amount 2005 $ million	Fair value 2005 $ million	Carrying amount 2004 $ million	Fair value 2004 $ million
Capital market instruments				
HK dollar Retail notes due 2008 and 2013 – see (c) below	**989**	**989**	1,020	1,043
US dollar notes due 2010 – see (d) below	**7,753**	**8,522**	7,785	8,998
US dollar notes due 2009 – see (e) below	**7,856**	**8,231**	7,771	8,654
HK dollar notes due 2013 – see (e) below	**789**	**789**	800	829
US dollar notes due 2014 – see (e) below	**387**	**444**	388	459
	17,774	**18,975**	17,764	19,983
Export credit loans – see (f) below	**1,700**	**1,706**	1,984	2,033
	19,474	**20,681**	19,748	22,016

(b) The fair values of capital market instruments and export credit loans were determined using discounted cash flow techniques.

(c) The Corporation issued 3% notes due 2008 with an aggregate nominal value of HK$300 million at a premium and 4.8% notes due 2013 with an aggregate nominal value of HK$700 million at a premium on 6 June 2003. All the notes issued are unsecured and ranked equally with all of the Corporation's other unsecured senior indebtedness.

(d) The Corporation issued 8% notes due 2010 with an aggregate nominal value of US$1 billion at a discount on 16 March 2000. These notes are registered with the United States Securities and Exchange Commission and listed on the Stock Exchange of Hong Kong Limited, the London Stock Exchange plc and the New York Stock Exchange, Inc. All the notes issued are unsecured and ranked equally with all of the Corporation's other unsecured senior indebtedness.

(e) The Corporation issued 7.25% notes due 2009 with an aggregate nominal value of US$1 billion at a discount on 27 July 1999, 7.77% notes due 2014 with an aggregate nominal value of US$50 million at a discount on 17 November 1999, and 4.65% notes due 2013 with an aggregate nominal value of HK$800 million at par on 9 June 2003 under its US$3 billion medium term note programme. All the notes issued are unsecured and ranked equally with all of the Corporation's other unsecured senior indebtedness.

29 Interest-bearing borrowings *(continued)*

(f) During the year, the Corporation has repaid US$33.4 million under a US$337.7 million export credit loan facility provided by Japan Bank for International Cooperation. As at 31 December 2005, the outstanding balance of the facility amounted to US$186.8 million, of which about 78% bore interest at a fixed rate and the remaining 22% bore interest at a rate of LIBOR plus a margin. The loan is unsecured and repayable by seventeen semi-annual instalments commencing on 21 April 2003. The loan ranks equally with all of the Corporation's other unsecured senior indebtedness.

During the year, US$2.3 million has been drawn and US$4.7 million has been repaid by the Corporation under a US$42 million export credit loan facility provided by Export Development Canada. As at 31 December 2005, the outstanding balance of the facility amounted to US$31.6 million, which bore interest at a rate of LIBOR plus a margin. The loan is unsecured and repayable by seventeen semi-annual instalments commencing on 4 May 2004. The loan ranks equally with all of the Corporation's other unsecured senior indebtedness.

(g) The covenants attached to the Corporation's interest-bearing borrowings are customary ones. There is only one financial covenant which is contained in the agreement for the export credit loan provided by Japan Bank for International Cooperation, under which the Corporation covenants that its tangible net worth is not, at any time, less than the Hong Kong dollar equivalent of US$1,200 million.

(h) At 31 December 2005, the interest-bearing borrowings were repayable as follows:

	Capital market instruments 2005 $ million	**Export credit loans 2005 $ million**	**Total 2005 $ million**	Total 2004 $ million
Within one year	**–**	**299**	**299**	299
After one year but within two years	**–**	**304**	**304**	300
After two years but within five years	**15,901**	**916**	**16,817**	8,991
After five years	**1,873**	**181**	**2,054**	10,158
	17,774	**1,700**	**19,474**	19,748

30 Deferred income

(a) The balance of deferred income includes cash received from property developers for property development sites along East Rail and Ma On Shan Rail, cash receipts arising from the lease out and lease back arrangements and cash received from the telecommunication operators for the leasing of telecommunication networks. The cash received from property developers will be utilised for costs to be incurred by the Corporation in respect of the relevant property development. The unutilised balance will be credited to income statement when the property enabling works are completed and accepted for development and after taking into account the outstanding risks and obligations in connection with the development, if any, retained by the Corporation. The balance relating to the lease out and lease back arrangements and telecommunication networks is amortised and credited to income statement over the applicable lease terms.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

30 Deferred income *(continued)*

(b) Movements on deferred income comprise:

	Group		Corporation	
	2005	2004	**2005**	2004
	$ million	$ million	**$ million**	$ million
Balance at 1 January	**708**	743	**663**	707
Net amount received and receivable	**76**	12	**76**	–
Provision for amount payable upon termination of a lease arrangement (see note 26 (a))	**(196)**	–	**(196)**	–
Recognised in the income statement	**(47)**	(47)	**(42)**	(44)
Balance at 31 December	**541**	708	**501**	663

(c) Deferred income is expected to be recognised in the income statement as follows:

	Group		Corporation	
	2005	2004	**2005**	2004
	$ million	$ million	**$ million**	$ million
Within one year	**32**	48	**27**	43
After one year	**509**	660	**474**	620
	541	708	**501**	663

31 Share capital

	2005		2004	
	No. of shares	**$ million**	No. of shares	$ million
Share capital:				
Authorised:				
Shares of $100,000 each	**425,000**	**42,500**	425,000	42,500
Issued and fully paid:				
At 31 December	**391,200**	**39,120**	391,200	39,120

32 Reserves

The Group

	Development reserve $ million	Investments revaluation reserve $ million	Investment property revaluation reserve $ million	Retained profits $ million	Total $ million
Balance at 1 January 2004					
– as previously reported	6,535	(1)	117	14,434	21,085
– prior period adjustments arising from changes in accounting policies	–	–	(117)	96	(21)
– as restated	6,535	(1)	–	14,530	21,064
Dividend approved in respect of the previous year	–	–	–	(620)	(620)
Net surplus/(deficit) arising from revaluation					
– as previously reported	–	(54)	148	–	94
– prior period adjustments arising from changes in accounting policies	–	–	(148)	–	(148)
– as restated	–	(54)	–	–	(54)
Net deficit transferred to the income statement on redemption and disposal	–	39	–	–	39
	–	(15)	–	–	(15)
Profit for the year					
– as previously reported				429	429
– prior period adjustments arising from changes in accounting policies				84	84
– as restated				513	513
Balance at 31 December 2004 (as restated)	6,535	(16)	–	14,423	20,942
Balance at 1 January 2005 (after prior period adjustments)	**6,535**	**(16)**	**–**	**14,423**	**20,942**
– opening balance adjustments arising from changes in accounting policies	**–**	**–**	**–**	**(568)**	**(568)**
– as restated	**6,535**	**(16)**	**–**	**13,855**	**20,374**
Transfer to retained profits	**(6,535)**	**–**	**–**	**6,535**	**–**
Net deficit arising from revaluation	**–**	**(15)**	**–**	**–**	**(15)**
Net deficit transferred to the income statement on redemption and disposal	**–**	**29**	**–**	**–**	**29**
	–	**14**	**–**	**–**	**14**
Dividend approved in respect of the previous year	**–**	**–**	**–**	**(172)**	**(172)**
Profit for the year	**–**	**–**	**–**	**317**	**317**
Balance at 31 December 2005	**–**	**(2)**	**–**	**20,535**	**20,533**

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

32 Reserves *(continued)*

The Corporation

	Development reserve $ million	Investments revaluation reserve $ million	Investment property revaluation reserve $ million	Retained profits $ million	Total $ million
Balance at 1 January 2004					
– as previously reported	6,535	(1)	117	14,400	21,051
– prior period adjustments arising from changes in accounting policies	–	–	(117)	96	(21)
– as restated	6,535	(1)	–	14,496	21,030
Dividend approved in respect of the previous year	–	–	–	(620)	(620)
Net surplus/(deficit) arising from revaluation					
– as previously reported	–	(54)	148	–	94
– prior period adjustments arising from changes in accounting policies	–	–	(148)	–	(148)
– as restated	–	(54)	–	–	(54)
Net deficit transferred to the income statement on redemption and disposal	–	39	–	–	39
	–	(15)	–	–	(15)
Profit for the year					
– as previously reported				418	418
– prior period adjustments arising from changes in accounting policies				84	84
– as restated				502	502
Balance at 31 December 2004 (as restated)	6,535	(16)	–	14,378	20,897
Balance at 1 January 2005 (after prior period adjustments)	**6,535**	**(16)**	**–**	**14,378**	**20,897**
– opening balance adjustments arising from changes in accounting policies	**–**	**–**	**–**	**(568)**	**(568)**
– as restated	**6,535**	**(16)**	**–**	**13,810**	**20,329**
Transfer to retained profits	**(6,535)**	**–**	**–**	**6,535**	**–**
Net deficit arising from revaluation	**–**	**(15)**	**–**	**–**	**(15)**
Net deficit transferred to the income statement on redemption and disposal	**–**	**29**	**–**	**–**	**29**
	–	**14**	**–**	**–**	**14**
Dividend approved in respect of the previous year	**–**	**–**	**–**	**(172)**	**(172)**
Profit for the year	**–**	**–**	**–**	**336**	**336**
Balance at 31 December 2005	**–**	**(2)**	**–**	**20,509**	**20,507**

32 Reserves *(continued)*

(a) Included in the retained profits of the Group is an amount of $30 million (2004: $48 million) being the retained profits attributable to an associate.

(b) The development reserve represents appropriations of all profits from property developments to retained reserves within the Corporation. The development reserve was created in accordance with the relevant provisions of the Ordinance.

In 2005, the balance of the development reserve was transferred to retained profits upon the approval from the Financial Secretary of the Government in accordance with the relevant provisions of the Ordinance.

(c) Pursuant to the relevant provisions of the Ordinance, the reserves available for distribution comprise an amount out of the whole or part of the profits of the Corporation in any financial year after making allowance for any sums carried to the credit of the development reserve and any accumulated loss at the end of the financial year prior to the year in which the distribution is declared. The fair value change of financial assets and liabilities and investment properties, net of related deferred tax, recognised in retained profit are not available for distribution to the sole shareholder because they are not realised profits of the Corporation. As at 31 December 2005, the amount of reserves available for distribution to the sole shareholder amounted to $20,384 million (2004: $14,143 million as restated).

33 Financial assets and liabilities

In the normal course of its business, the Corporation is exposed to a variety of financial risks: foreign exchange risk, interest rate risk, credit risk and liquidity risk. The Corporation uses derivative financial instruments to hedge certain risk exposures.

The Managing Board has approved policies in respect of foreign exchange risk, interest-rate risk, credit risk, use of derivative financial instruments and investment of surplus funds. As part of its risk management, the Corporation identifies and evaluates the financial risks and, where appropriate, hedges those risks in accordance with the policies established by the Managing Board.

The Corporation documents at the inception of each hedging transaction the relationship between the hedging instrument and hedged item, as well as its risk management objective and strategy for undertaking the transaction. The Corporation also documents its assessment, both at inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are effective in offsetting changes in fair values or cash flows of the hedged items.

(a) Credit risk

The Corporation's credit risk is primarily attributable to its investment in debt securities, its deposits and over-the-counter derivative financial instruments entered into for hedging purposes.

The Corporation has no significant concentrations of credit risk. It has policies in place that limit the amount of credit exposure to any financial institution with which the Corporation has transactions. The Corporation can only invest in debt securities issued by or place deposits with financial institutions that meet the established credit rating or other criteria. Derivative counter parties are limited to high-credit-quality financial institutions. The exposures to these credit risks are monitored on an ongoing basis.

The maximum exposure to credit risk is represented by the carrying amount of each financial asset, including derivative financial assets and liabilities, in the balance sheet.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

33 Financial assets and liabilities *(continued)*

(b) Interest rate risk

(i) Hedging

The Corporation's interest rate risk arises from its long-term borrowings. Borrowings at variable rates expose the Corporation to cash flow interest rate risk. Borrowings at fixed rates expose the Corporation to fair value interest rate risk. The Corporation aims to maintain the proportion of its fixed rate borrowings at between 30% and 75% of total borrowings. At the year end, 73% of total borrowings were at fixed rates.

The Corporation enters into receive-fixed-pay-floating interest rate swaps to hedge the fair value interest rate risk arising from fixed rate borrowings as well as to achieve an appropriate mix of fixed and floating rate exposure.

At 31 December 2005, the Corporation had interest rate swaps with a notional contract amount of $3,356 million (1 January 2005: $3,361 million) which qualify as fair value hedges. These interest rate swaps are stated at fair value with changes in fair value being recognised in the income statement to offset the effect of the gain or loss on the related hedged portion of interest-bearing borrowings.

The net fair value of interest rate swaps entered into by the Corporation at 31 December 2005 was $88 million (1 January 2005: $271 million) comprising assets of $124 million (1 January 2005: $271 million) and liabilities of $36 million (1 January 2005: nil). These amounts are recognised as derivative financial assets and liabilities.

Occasionally, the Corporation manages its cash flow interest rate risk by using receive-floating-pay-fixed interest rate swaps. There were no such swaps outstanding as at 31 December 2005.

(ii) Fair value through income statement

For interest rate swaps where the hedging relationships do not qualify as fair value hedges, changes in their fair values are recognised in the income statement.

At 31 December 2005, the Corporation had such interest rate swaps with notional contract amount of $1,362 million (1 January 2005: $781 million) and fair value of $40 million (1 January 2005: $22 million) which are recognised as derivative financial liabilities.

(iii) Effective interest rate and repricing analysis

In respect of income-earning financial assets and interest-bearing financial liabilities, the following table indicates their effective interest rates at the balance sheet date and the periods in which they will be repriced or are mature.

33 Financial assets and liabilities *(continued)*

(b) Interest rate risk *(continued)*

(iii) Effective interest rate and repricing analysis *(continued)*

2005

	Effective interest rate %	Total $ million	One year or less $ million	1-2 years $ million	2-5 years $ million	More than 5 years $ million
Repricing dates for assets/ (liabilities) which are repriced before maturity						
The Group and the Corporation						
Investments	3.87	331	331	–	–	–
Loan to non-controlled subsidiary	8.24	3,863	3,863	–	–	–
Interest-bearing borrowings	4.94	(571)	(571)	–	–	–
		3,623	3,623	–	–	–
Maturity dates for assets/ (liabilities) which are not repriced before maturity						
The Group						
Loans to third party	6.96	684	34	36	124	490
Investments	2.95	118	118	–	–	–
Cash and cash equivalents	4.03	3,394	3,394	–	–	–
Lease payable	6.96	(684)	(34)	(36)	(124)	(490)
Interest-bearing borrowings	7.15	(18,903)	–	(199)	(16,698)	(2,006)
Effect of interest rate swaps	(0.74)	–	4,781	–	(3,295)	(1,486)
		(15,391)	8,293	(199)	(19,993)	(3,492)
The Corporation						
Investments	2.95	118	118	–	–	–
Cash and cash equivalents	4.03	3,270	3,270	–	–	–
Interest-bearing borrowings	7.15	(18,903)	–	(199)	(16,698)	(2,006)
Effect of interest rate swaps	(0.74)	–	4,781	–	(3,295)	(1,486)
		(15,515)	8,169	(199)	(19,993)	(3,492)

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

33 Financial assets and liabilities *(continued)*

(b) Interest rate risk *(continued)*

(iii) Effective interest rate and repricing analysis *(continued)*

2004

	Effective interest rate %	Total $ million	One year or less $ million	1-2 years $ million	2-5 years $ million	More than 5 years $ million
Repricing dates for assets/ (liabilities) which are repriced before maturity						
The Group and the Corporation						
Investments	2.47	609	609	–	–	–
Loan to non-controlled subsidiary	7.50	3,576	3,576	–	–	–
Interest-bearing borrowings	2.77	(851)	(851)	–	–	–
		3,334	3,334	–	–	–
Maturity dates for assets/ (liabilities) which are not repriced before maturity						
The Group						
Loans to third party	6.92	733	31	34	116	552
Investments	1.30	3,714	3,613	101	–	–
Cash and cash equivalents	2.05	3,531	3,531	–	–	–
Lease payable	6.96	(717)	(31)	(34)	(116)	(536)
Interest-bearing borrowings	7.20	(18,897)	–	–	(8,808)	(10,089)
Effect of interest rate swaps	(1.82)	–	4,153	–	(1,857)	(2,296)
		(11,636)	11,297	101	(10,665)	(12,369)
The Corporation						
Loans to third party	5.35	16	–	–	–	16
Investments	1.30	3,714	3,613	101	–	–
Cash and cash equivalents	2.10	3,426	3,426	–	–	–
Interest-bearing borrowings	7.20	(18,897)	–	–	(8,808)	(10,089)
Effect of interest rate swaps	(1.82)	–	4,153	–	(1,857)	(2,296)
		(11,741)	11,192	101	(10,665)	(12,369)

33 Financial assets and liabilities *(continued)*

(c) Foreign exchange risk

The Corporation derives its revenues almost entirely in Hong Kong dollars and is therefore exposed to foreign exchange risk arising from borrowings, purchases, and capital expenditure payments in relation to the development of new railways that are denominated in foreign currencies.

The Corporation uses forward exchange contracts and currency swaps to hedge its foreign exchange risk. The Corporation's risk management policy is to hedge its foreign currency borrowings into either Hong Kong dollars or United States dollars and limit its exposure to United States dollars to no greater than 30% of its total borrowings. Any contract for purchases or capital expenditure denominated in foreign currencies and exceeding $10 million equivalent is required to be reported to Corporate Treasury, which uses forward contracts to hedge the related foreign currency risk as and when necessary.

The Corporation may have investments in debt securities and other financial assets from time to time. Where these investments are denominated in foreign currencies other than United States dollars or Hong Kong dollars, the Corporation hedges the exposure into either United States dollars or Hong Kong dollars.

(i) Recognised assets and liabilities

Changes in the fair value of currency swaps that economically hedge monetary assets and liabilities in foreign currencies are recognised in the income statement. The net fair value of currency swaps used by the Corporation as economic hedges of monetary assets and liabilities in foreign currencies at 31 December 2005 and recognised as derivative financial liabilities was $283 million (1 January 2005: $691 million).

(ii) Fair value through income statement

Changes in the fair value of forward exchange contracts for which no hedge accounting is applied are recognised in the income statement. The net fair value of forward exchange contracts recognised as net derivative financial assets was $3 million (1 January 2005: $17 million of net derivative financial liabilities), which comprises assets of $5 million (1 January 2005: $11 million) and liabilities of $2 million (1 January 2005: $28 million).

In respect of other receivables and other payables denominated in currencies other than the functional currency of the operations, the Corporation ensures that the net exposure is kept to an acceptable level by buying or selling foreign currencies at spot or forward rates where necessary.

All the Corporation's borrowings are denominated in either Hong Kong dollars or United States dollars. Given this, management does not expect that there will be any significant currency risk associated with the Corporation's borrowings.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

33 Financial assets and liabilities *(continued)*

(c) Foreign exchange risk *(continued)*

(iii) The financial assets and liabilities denominated in currencies other than the functional currency of the Corporation are shown as follows:

	Group		Corporation	
	2005 million	2004 million	**2005 million**	2004 million
	(Expressed in foreign currency)			
US dollars				
Non-derivative financial assets				
– Loans to third party	**88**	94	**–**	2
– Investments	**55**	302	**55**	302
– Interest and other receivables	**6**	6	**4**	4
– Cash and cash equivalents	**292**	416	**292**	416
	441	818	**351**	724
Derivative financial assets				
– Interest rate swaps	**16**	28	**16**	28
– Forward exchange contracts	**1**	1	**1**	1
	17	29	**17**	29
Non-derivative financial liabilities				
– Interest and other payables	**87**	59	**85**	57
– Accrued charges and provisions for capital projects	**5**	21	**5**	21
– Lease payable	**88**	92	**–**	–
– Interest-bearing borrowings	**2,274**	2,296	**2,274**	2,296
	2,454	2,468	**2,364**	2,374
Derivative financial liabilities				
– Interest rate swaps	**5**	3	**5**	3
– Currency swaps	**36**	89	**36**	89
– Forward exchange contracts	**–**	4	**–**	4
	41	96	**41**	96
EURO				
Non-derivative financial assets				
– Cash and cash equivalents	**1**	–	**1**	–
Derivative financial assets				
– Forward exchange contracts	**–**	1	**–**	1
JPY				
Derivative financial assets				
– Forward exchange contracts	**–**	5	**–**	5
Derivative financial liabilities				
– Forward exchange contracts	**1**	–	**1**	–
CHF				
Non-derivative financial assets				
– Cash and cash equivalents	**8**	–	**8**	–

33 Financial assets and liabilities *(continued)*

(d) Liquidity risk

The Corporation aims to secure committed credit facilities well ahead of funding needs. This protects the Corporation against possible adverse market conditions which result in difficulties in raising funds to meet payment obligations. The Corporation has put in place committed revolving facilities and uncommitted stand-by facilities to cater for short-term liquidity requirements.

(e) Fair value

The fair values of all financial assets and liabilities are set out in the following tables except for those financial assets and liabilities with carrying amounts not materially different from their fair values as at 31 December 2005 and 31 December 2004.

The Group

	Carrying amount 2005 $ million	**Fair value 2005 $ million**	Carrying amount 2004 $ million	Fair value 2004 $ million
Non-derivative financial assets				
– Loans to third party	**684**	**668**	733	732
– Loan to non-controlled subsidiary	**3,863**	**4,105**	3,576	3,939
	4,547	**4,773**	4,309	4,671
Derivative financial assets				
– Interest rate swaps	**124**	**124**	#	271
– Forward exchange contracts	**5**	**5**	#	11
	129	**129**	#	282
Non-derivative financial liabilities				
– Lease payable	**(684)**	**(668)**	(717)	(715)
– Interest-bearing borrowings	**(19,474)**	**(20,681)**	(19,748)	(22,016)
	(20,158)	**(21,349)**	(20,465)	(22,731)
Derivative financial liabilities				
– Interest rate swaps	**(76)**	**(76)**	#	(22)
– Currency swaps	**(283)**	**(283)**	#	(691)
– Forward exchange contracts	**(2)**	**(2)**	#	(28)
	(361)	**(361)**	#	(741)

In accordance with the transitional provisions of HKAS 39, adjustments to the balance sheet as at 31 December 2004 to reflect the fair values of derivative financial instruments held at that date are not required.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

33 Financial assets and liabilities *(continued)*

(e) Fair value *(continued)*

The Corporation

	Carrying amount 2005 $ million	**Fair value 2005 $ million**	Carrying amount 2004 $ million	Fair value 2004 $ million
Non-derivative financial assets				
– Loans to third party	**–**	**–**	16	17
– Loan to non-controlled subsidiary	**3,863**	**4,105**	3,576	3,939
	3,863	**4,105**	3,592	3,956
Derivative financial assets				
– Interest rate swaps	**124**	**124**	#	271
– Forward exchange contracts	**5**	**5**	#	11
	129	**129**	#	282
Non-derivative financial liabilities				
– Interest-bearing borrowings	**(19,474)**	**(20,681)**	(19,748)	(22,016)
Derivative financial liabilities				
– Interest rate swaps	**(76)**	**(76)**	#	(22)
– Currency swaps	**(283)**	**(283)**	#	(691)
– Forward exchange contracts	**(2)**	**(2)**	#	(28)
	(361)	**(361)**	#	(741)

\# *In accordance with the transitional provisions of HKAS 39, adjustments to the balance sheet as at 31 December 2004 to reflect the fair values of derivative financial instruments held at that date are not required.*

(f) Estimation of fair value

The following summarises the major methods and assumptions used in estimating the fair values of financial assets and liabilities reflected in the tables set out in note 33(e) above.

(i) Investments

The fair value of financial assets traded in active markets was based on quoted market prices at the balance sheet date.

(ii) Interest rate swaps, currency swaps and forward exchange contracts

The fair value of interest rate swaps and currency swaps was the present value of the estimated amount that the Group would receive or pay to terminate the swap at the balance sheet date, taking into account prevailing interest rates, foreign exchange rates and creditworthiness of the swap counterparties. The fair value of forward exchange contracts was the quoted market price at the balance sheet date, being the present value of the quoted forward price. Discounted cash flows techniques were used in determining the fair value of swaps.

33 Financial assets and liabilities *(continued)*

(f) Estimation of fair value *(continued)*

(iii) Loan to non-controlled subsidiary and interest-bearing borrowings

Where applicable, fair value was calculated based on discounted cash flows of expected future principal and interest payments.

(iv) Loans to third party and lease payable

The fair value was estimated as the present value of future cash flows.

(v) Discount rates used for determining fair value

The Corporation used the applicable yield curve at the balance sheet date plus an adequate constant credit spread to discount financial assets and liabilities. The interest rates used were as follows:

	2005	2004
Interest rate swaps, currency swaps	**4.22% - 5.43%**	0.32% - 4.56%
Loan to non-controlled subsidiary and interest-bearing borrowings	**4.05% - 5.82%**	0.22% - 5.68%
Loans to third party and lease payable	**7.43% - 7.83%**	5.35% - 7.97%

34 Notes to the consolidated cash flow statement

Reconciliation of operating profit before interest and finance income/expenses to net cash inflow from operations

	2005 **$ million**	2004 Restated $ million
Operating profit before interest and finance income/expenses	**98**	491
Depreciation	**2,140**	1,569
Amortisation of interest in leasehold land held for own use under operating leases	**118**	112
Fixed assets written off	**43**	24
Increase in stores and spares	**(24)**	(65)
Decrease/(increase) in other receivables	**194**	(262)
Increase/(decrease) in other payables and deferred income	**(177)**	440
Decrease in loans to third party	**16**	–
Net cash inflow from operations	**2,408**	2,309

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

35 Related parties

The Corporation is wholly owned by the Government. The Corporation has entered into transactions with the Government in respect of the developments of the West Rail, Phase I route, East Rail Extensions and Kowloon Southern Link which are considered to be related party transactions under HKAS 24 and these are disclosed in notes 1, 2(c), 6, 14(j), 15(c), (d) and (e), 16(b) and (c), 17, 18, 21, 24 and 27 to the financial statements. Transactions with Government departments and agencies in the course of their normal dealings with the Corporation are not considered to be related party transactions.

Members of the Managing Board, the Executive Directors who are not Members of the Managing Board, members of the Management Committee and parties related to them are also related parties of the Corporation. During the year there were no significant transactions with any such parties other than their remuneration which is disclosed in note 6 to the financial statements.

The Corporation and four other local transport companies (including the MTR Corporation Limited) entered into an agreement in 1994 to develop and operate the Octopus cards system through a central body called Octopus Cards Limited. During the year, Octopus Cards Limited earned fees for the use of the Octopus cards system from the Corporation and paid ticket loading agent fees and handling fees to the Corporation. Details of the transactions are disclosed in note 19 to the financial statements.

36 Outstanding commitments

(a) Commitments outstanding in respect of capital expenditure not provided for in the financial statements were as follows:

	2005 $ million	2004 $ million
Investment properties		
– authorised and contracted for	**41**	1
– authorised but not contracted for	**7**	51
Property, plant and equipment		
– authorised and contracted for	**4,093**	2,601
– authorised but not contracted for	**3,778**	1,964
Interest in leasehold land held for own use		
– authorised and contracted for	**291**	349
– authorised but not contracted for	**30**	–
Balance at 31 December	**8,240**	4,966

36 Outstanding commitments *(continued)*

(b) The total future minimum lease payments under non-cancellable operating leases for property with varying terms and renewal rights are payable as follows:

	2005 $ million	2004 $ million
Within one year	**46**	40
After one year but within five years	**94**	18
Balance at 31 December	**140**	58

The operating leases are mainly related to work areas used for construction of new railways. During the year, amounts payable under operating leases totalling nil (2004: $54 million) were capitalised as part of construction in progress or deferred expenditure, as appropriate.

37 Retirement benefit scheme

The Kowloon-Canton Railway Corporation Retirement Benefit Scheme ("RBS Scheme") was established on 1 February 1983 under trust. With effect from 16 November 1994, the RBS Scheme has been registered under Section 18 of the Occupational Retirement Schemes Ordinance.

All benefits payable under the RBS Scheme are calculated by reference to the Corporation's contributions and members' own contributions, together with investment returns on these contributions.

For members joining the RBS Scheme before 1 January 2000, the Corporation's contribution rates are 12% and 16% of the respective salaries of non-management staff and management staff. For members joining on or after 1 January 2000, the Corporation's contribution rates for the first eight years are 8% and 12% of the respective salaries of non-management staff and management staff and, thereafter, the contribution rates will be 10% and 15% of the respective salaries of non-management staff and management staff.

Where employees leave the RBS Scheme prior to their entitlement to all or part of the Corporation's contributions vesting fully, such contributions shall be used to reduce the future contributions of the Corporation due under the RBS Scheme.

The Group also operates a Mandatory Provident Fund Scheme ("MPF Scheme") under the Hong Kong Mandatory Provident Fund Schemes Ordinance. The MPF Scheme is a defined contribution retirement plan administrated by independent trustees. Under the MPF Scheme, the employer and its employees are each required to make contributions to the plan at 5% of the employees' relevant income, subject to a cap of monthly relevant income of $20,000. The MPF Scheme was introduced on 1 April 2000 to employees who did not opt for or who were not eligible for RBS Scheme.

The Group's total retirement cost charged to the income statement includes the retirement costs for both RBS and MPF Schemes.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

38 Debt facilities and programmes

(a) Total unutilised debt facilities and programmes available to the Corporation comprise:

	2005 $ million	2004 $ million
$2,200 million (2004: $1,650 million) short-term uncommitted revolving credit facilities	**2,200**	1,650
$20 million (2004: $20 million) letters of credit	**20**	20
$25 million (2004: $25 million) overdraft facilities	**25**	25
$8,000 million (2004: $8,000 million) syndicated loan facilities	**8,000**	8,000
US$3,000 million (2004: US$3,000 million) medium term note programme	**14,377**	14,425
US$292 million (2004: US$292 million) letters of credit for leveraged leases	**2,273**	2,280
US$220 million (2004: US$258 million) export credit loan facilities	**11**	29
	26,906	26,429

(b) The unutilised debt facilities are expected to expire as follows:

	2005 $ million	2004 $ million
Floating rate		
– expiring within one year	**2,245**	2,624
– expiring after one year	**10,284**	9,380
Fixed/floating rate to be determined when issued		
– expiring after one year	**14,377**	14,425
	26,906	26,429

39 Contingent liabilities

At 31 December 2005, the Group had contingent liabilities arising from certain contractors' claims in respect of the contracts for the construction of the West Rail and East Rail Extensions projects where the Group's total obligations cannot be estimated reliably. The Group has made provision in the financial statements at 31 December 2005 for its best estimate of amounts which are likely to be payable in connection with these claims. The amounts payable upon resolution of the claims may be eventually in excess of amounts estimated by the Group and accounted for in the financial statements at 31 December 2005. The Group is in the process of resolving these claims.

40 Impairment of assets

At 31 December 2005 the Group assessed whether there was any impairment of the Group's fixed assets at that date in accordance with the Group's accounting policies for the assessment of asset impairment.

In assessing the value in use of the Group's railway assets, the entire railway network, current and committed, has been treated as representing the smallest cash-generating unit on the basis that once the Kowloon Southern Link ("KSL") is completed in 2009, the current East Rail and West Rail networks will be linked and it will not be possible to allocate passenger revenue to any specific part of the network. The project agreement for the KSL with the Government was signed on 6 October 2005.

The estimated cash flows of the railway network were calculated for a period consistent with the estimated useful lives of the core assets of the railway network and were discounted using the Corporation's weighted average cost of capital at 31 December 2005.

As a result of this assessment, management considers that the railway assets of the Group are not impaired at 31 December 2005 and, accordingly, that no provision for impairment of the Group's railway assets is required at that date.

41 Possible merger of the Corporation and MTR Corporation Limited

On 24 February 2004, the Government invited the two railway corporations to commence negotiations on a possible merger. On 16 September 2004, the two corporations submitted their Joint Merger Report to the Government on the outcome of their negotiations, including preliminary transaction terms and the framework of a draft operating agreement with key terms on, inter alias, the fare adjustment mechanism, and safeguards and measures to deal with service disruption. According to the policy address of the Chief Executive of the Government announced on 12 October 2005, the Government will make a public announcement on the possible merger as soon as the outcome is known.

These financial statements have not included any adjustments to the carrying value of assets or liabilities which may be required once the Government announces the results of its study of the report as it is uncertain what will be the outcome and the consequent effect on the Corporation's operations and financial condition.

42 Comparative figures

Certain comparative figures have been adjusted as a result of the changes in accounting policies. Further details are disclosed in note 3.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

43 Accounting estimates and judgements

(a) Key sources of estimation uncertainty

Note 33 contains information about the assumptions and their risk factors relating to financial instruments. Other key sources of estimation uncertainty include the assessment of useful lives for depreciation of fixed assets (see note 2(j)), assessment of provisions and contingent liabilities (see notes 2(aa), 27 and 39), determination of the recoverability of deferred tax assets (see note 10(d)), the valuation of investment properties (see note 14(f)) and assessment of the possibility of implementation of Shatin to Central Link project (see note 16(a)).

(b) Critical accounting judgements in applying the Group's accounting policies

Critical accounting judgements in applying the Group's accounting policies include the classification of revenue and expenditure as capital or revenue in nature (see note 2(i)(i)), the classification of revenue and cost-recovery, the classification of operating leases or lease-out and lease-back transactions, transfers from construction in progress to fixed assets (see note 2(m)), assessment of controlled and non-controlled subsidiaries (see note 2(c)), the categorisation of financial assets and liabilities, adoption of hedge accounting (see note 33) and impairment of assets (see note 40).

44 Possible impact of amendments, new standards and interpretations issued but not yet effective for the annual accounting period ended 31 December 2005

Up to the date of issue of these financial statements, the HKICPA has issued several amendments to existing accounting standards, new standards and interpretations which are not yet effective for the accounting period ended 31 December 2005 and have not been adopted in these financial statements.

In addition, the Hong Kong Companies (Amendment) Ordinance 2005 which came into effect on 1 December 2005 will first be applicable to the Group's financial statements for the period beginning 1 January 2006.

The Group is in the process of making an assessment of the impact of these amendments, new standards and new interpretations in the period of initial application. The preliminary results of this assessment indicate that none of the amendments, new standards and new interpretations are likely to have a significant impact on the Group's results of operations and financial position.

Consolidated Income Statement

for the year ended 31 December 2005 (Expressed in foreign currencies)

	Note	2005 US$ million	2005 GBP million	2005 JPY million
Turnover	4	**690**	**400**	**80,814**
Operating costs before depreciation	5	**403**	**234**	**47,215**
Operating profit before depreciation	6	**287**	**166**	**33,599**
Depreciation	7	**274**	**159**	**32,127**
Operating profit before interest and finance income/expenses		**13**	**7**	**1,472**
Interest and finance income	8(a)	**67**	**39**	**7,882**
Interest and finance expenses	8(b)	**(106)**	**(61)**	**(12,356)**
Loss after depreciation, interest and finance income/expenses		**(26)**	**(15)**	**(3,002)**
Gains on changes in fair value of derivative financial instruments and hedged borrowings	9	**52**	**30**	**6,005**
Valuation gains on investment properties	14	**22**	**13**	**2,567**
Share of profit of associate		**2**	**1**	**225**
Profit before taxation		**50**	**29**	**5,795**
Income tax	10(a)	**(9)**	**(5)**	**(1,036)**
Profit for the year wholly attributable to the sole shareholder of the Corporation	11	**41**	**24**	**4,759**

The foreign currency figures shown are for reference purposes only and are converted from Hong Kong dollars at the following exchange rates: US$1=HK$7.80, GBP1=HK$13.451 and JPY1=HK$0.06661

Consolidated Balance Sheet

at 31 December 2005 (Expressed in foreign currencies)

	Note	2005 US$ million	2005 GBP million	2005 JPY million
Assets				
Fixed assets	14			
– Property, plant and equipment		**7,709**	**4,470**	**902,672**
– Investment properties		**150**	**87**	**17,580**
		7,859	**4,557**	**920,252**
Interest in leasehold land held for own use under operating leases	14	**724**	**420**	**84,747**
Construction in progress	15	**1,335**	**774**	**156,298**
Deferred expenditure	16	**155**	**90**	**18,165**
Properties under development	17	**197**	**114**	**23,075**
Interest in associate	19	**9**	**5**	**1,081**
Loans to third party	20	**87**	**51**	**10,269**
Loan to non-controlled subsidiary	21	**495**	**287**	**57,994**
Derivative financial assets	33(e)	**17**	**10**	**1,937**
Investments	22	**58**	**33**	**6,741**
Stores and spares	23	**44**	**26**	**5,149**
Interest and other receivables	24	**92**	**53**	**10,764**
Cash and cash equivalents	25	**435**	**253**	**50,953**
		11,507	**6,673**	**1,347,425**
Liabilities				
Interest and other payables	26	**359**	**208**	**42,081**
Accrued charges and provisions for capital projects	27	**389**	**226**	**45,609**
Lease payable	28	**88**	**51**	**10,269**
Derivative financial liabilities	33(e)	**46**	**27**	**5,419**
Interest-bearing borrowings	29	**2,497**	**1,448**	**292,358**
Deferred income	30	**70**	**40**	**8,122**
Deferred tax liabilities	10(d)	**410**	**238**	**48,011**
		3,859	**2,238**	**451,869**
Net Assets		**7,648**	**4,435**	**895,556**
Capital and Reserves				
Share capital	31	**5,015**	**2,908**	**587,299**
Reserves	32	**2,633**	**1,527**	**308,257**
Total equity		**7,648**	**4,435**	**895,556**

The foreign currency figures shown are for reference purposes only and are converted from Hong Kong dollars at the following exchange rates: US$1=HK$7.80, GBP1=HK$13.451 and JPY1=HK$0.06661

Corporation Balance Sheet

at 31 December 2005 (Expressed in foreign currencies)

	Note	2005 US$ million	2005 GBP million	2005 JPY million
Assets				
Fixed assets	14			
– Property, plant and equipment		**7,703**	**4,467**	**902,057**
– Investment properties		**150**	**87**	**17,580**
		7,853	**4,554**	**919,637**
Interest in leasehold land held for own use under operating leases	14	**724**	**420**	**84,747**
Construction in progress	15	**1,335**	**774**	**156,298**
Deferred expenditure	16	**155**	**90**	**18,165**
Properties under development	17	**197**	**114**	**23,075**
Interest in associate	19	**5**	**3**	**630**
Loan to non-controlled subsidiary	21	**495**	**287**	**57,994**
Derivative financial assets	33(e)	**17**	**10**	**1,937**
Investments	22	**58**	**33**	**6,741**
Stores and spares	23	**44**	**26**	**5,149**
Interest and other receivables	24	**91**	**53**	**10,614**
Cash and cash equivalents	25	**419**	**243**	**49,092**
		11,393	**6,607**	**1,334,079**
Liabilities				
Interest and other payables	26	**342**	**198**	**39,994**
Accrued charges and provisions for capital projects	27	**389**	**226**	**45,609**
Derivative financial liabilities	33(e)	**46**	**27**	**5,420**
Interest-bearing borrowings	29	**2,497**	**1,448**	**292,358**
Deferred income	30	**64**	**37**	**7,521**
Deferred tax liabilities	10(d)	**410**	**238**	**48,011**
		3,748	**2,174**	**438,913**
Net Assets		**7,645**	**4,433**	**895,166**
Capital and Reserves				
Share capital	31	**5,015**	**2,908**	**587,299**
Reserves	32	**2,630**	**1,525**	**307,867**
Total equity		**7,645**	**4,433**	**895,166**

The foreign currency figures shown are for reference purposes only and are converted from Hong Kong dollars at the following exchange rates: US$1=HK$7.80, GBP1=HK$13.451 and JPY1=HK$0.06661

Consolidated Statement of Changes in Equity

for the year ended 31 December 2005 (Expressed in foreign currencies)

	Note	2005 US$ million	2005 GBP million	2005 JPY million
Total equity at 1 January				
As previously reported		**7,711**	**4,472**	**902,973**
Prior period adjustments arising from changes in accounting policies in respect of:				
– depreciation of permanent way	3(a)(ii)	**(5)**	**(3)**	**(571)**
– deferred tax of valuation gains on investment properties	3(a)(ii) & 3(a)(iii)	**(6)**	**(4)**	**(706)**
As restated, before opening balance adjustments		**7,700**	**4,465**	**901,696**
Opening balance adjustments arising from changes in accounting policies under HKAS 32 and HKAS 39	32	**(73)**	**(42)**	**(8,527)**
At 1 January, after prior period and opening balance adjustments		**7,627**	**4,423**	**893,169**
Net expenses recognised directly in equity:				
Deficit on revaluation of available-for-sale securities	32	**(2)**	**(1)**	**(225)**
Net profit for the year	32	**41**	**24**	**4,759**
Revaluation deficit transferred to the income statement on redemption and disposal of available-for-sale securities	32	**4**	**2**	**435**
Dividend approved and paid during the year	12(b)	**(22)**	**(13)**	**(2,582)**
Total equity at 31 December		**7,648**	**4,435**	**895,556**

The foreign currency figures shown are for reference purposes only and are converted from Hong Kong dollars at the following exchange rates: US$1=HK$7.80, GBP1=HK$13.451 and JPY1=HK$0.06661

Consolidated Cash Flow Statement

for the year ended 31 December 2005 (Expressed in foreign currencies)

	Note	2005 US$ million	2005 GBP million	2005 JPY million
Operating activities				
Net cash inflow from operations	34	**309**	**179**	**36,151**
Net cash inflow from property development		**43**	**25**	**5,104**
Hong Kong profits tax paid		**–**	**–**	**(15)**
Net cash inflow from operating activities		**352**	**204**	**41,240**
Investing activities				
Increase in deposits with banks with maturity more than three months when placed		**(79)**	**(46)**	**(9,233)**
Payments for capital expenditure:				
– East Rail Extensions project		**(361)**	**(210)**	**(42,351)**
– other capital projects and purchase of fixed assets		**(278)**	**(161)**	**(32,548)**
Interest received		**96**	**56**	**11,260**
Dividend received from associate		**4**	**2**	**495**
Loan to non-controlled subsidiary		**(11)**	**(6)**	**(1,261)**
Loan to associate		**(4)**	**(2)**	**(495)**
Receipts on sales of fixed assets		**1**	**–**	**60**
Receipts on redemption and disposal of available-for-sale securities		**424**	**246**	**49,707**
Net cash outflow from investing activities		**(208)**	**(121)**	**(24,366)**
Net cash inflow before financing		**144**	**83**	**16,874**
Financing activities				
Net cash outflow on drawdown/repayment of loans		**(35)**	**(21)**	**(4,189)**
Dividend paid		**(22)**	**(13)**	**(2,582)**
Interest paid		**(178)**	**(103)**	**(20,898)**
Net cash flow relating to derivative financial instruments		**(2)**	**(1)**	**(195)**
Finance expenses paid		**(3)**	**(1)**	**(300)**
Net decrease in cash and cash equivalents		**(96)**	**(56)**	**(11,290)**
Cash and cash equivalents at 1 January		**332**	**193**	**38,898**
Cash and cash equivalents at 31 December		**236**	**137**	**27,608**
Analysis of the balances of cash and cash equivalents				
Cash at bank and in hand	25	**5**	**3**	**630**
Deposits with banks with maturity of less than three months when placed	25	**231**	**134**	**26,978**
		236	**137**	**27,608**

The foreign currency figures shown are for reference purposes only and are converted from Hong Kong dollars at the following exchange rates: US$1=HK$7.80, GBP1=HK$13.451 and JPY1=HK$0.06661

Ten-year Statistics

Financial (HK$ million)	**2005**	2004	2003	2002
Income Statement				
Revenue from operations	**5,383**	4,976	4,426	4,830
Operating profit before depreciation	**2,238**	2,060	2,297	2,659
Net interest and finance (income)/expenses	**298**	41	(353)	(618)
Profit/(loss) after depreciation, interest and finance income/expenses	**(200)**	450	1,902	2,552
Profit on property development	**–**	–	–	94
Net profit				
Before property development & related profits tax	**317**	513	1,381	2,116
After property development	**317**	513	1,381	2,210
Dividend	**–**	172	620	620
Balance Sheet				
Total assets	**89,752**	91,386	89,204	86,108
Net current assets/(liabilities)	**(1,387)**	(2,294)	(748)	1,397
Interest-bearing borrowings	**19,474**	19,748	20,013	17,753
Equity	**59,653**	60,062	60,205	59,512
Key financial data				
Capital expenditure	**3,835**	9,025	11,122	12,308
Return on equity (%)	**1**	1	2	4
Revenue per employee excluding project staff	**1.050**	0.994	0.950	1.222
Debt/equity ratio	**1:3.1**	1:3.0	1:3.0	1:3.4
Debt to total capitalisation (%)	**25**	25	25	23
Interest cover (times)	**1.9**	1.8	2.9	3.4

Certain comparative figures of 2004 have been restated to conform to the current year's presentation due to the adoption of the new HKFRS. Comparative figures before 2004 have not been restated because it is impractical to do so.

2001	2000	1999	1998	1997	1996
4,797	4,731	4,426	4,137	3,718	3,294
2,572	2,571	2,249	2,032	1,769	1,471
(490)	(302)	(222)	(164)	(20)	45
2,401	2,203	1,773	1,629	1,332	1,012
24	87	71	88	2,308	2,468
2,411	2,201	1,832	1,565	1,325	1,020
2,435	2,288	1,903	1,639	3,263	3,077
–	–	–	–	–	300
82,537	70,419	58,291	31,945	15,866	13,544
2,135	5,727	9,857	8,663	(674)	(315)
16,831	16,395	8,299	–	–	–
59,580	48,901	46,588	30,253	14,317	11,163
14,595	10,829	8,444	3,286	3,582	2,538
4	5	4	5	23	28
1.240	1.248	1.183	1.127	1.053	0.951
1:3.5	1:3.0	1:5.6	–	–	–
22	25	15	–	–	–
3.3	3.4	7.9	–	–	–

Ten-year Statistics

Operating (million)	**2005**	2004	2003	2002
East Rail including Tsim Sha Tsui Extension and Ma on Shan Rail*				
Total number of passengers	**325**	292	278	296
Domestic	**239**	207	196	204
Cross-boundary	**86**	85	82	92
Daily average number of passengers	**0.892**	0.799	0.762	0.812
Revenue car-km operated	**91.56**	79.35	78.68	78.92
Total passenger-km travelled	**4,731**	4,385	4,183	4,540
Safety performance (unit)				
Number of passengers & public injured	**247**	216	181	180
Passengers & public injured per million passengers carried	**0.71**	0.74	0.65	0.61
Through Train Operations				
Total number of passengers	**3.1**	3.0	2.1	2.3
Light Rail				
Total number of passengers	**136**	132	106	114
Daily average number of passengers	**0.373**	0.360	0.291	0.314
Revenue car-km operated	**11.09**	11.29	10.71	10.76
Safety performance (unit)				
Number of passengers & public injured	**23**	18	27	33
Passengers & public injured per million passengers carried	**0.17**	0.14	0.25	0.29
West Rail**				
Total number of passengers	**65**	48	1	–
Daily average number of passengers	**0.179**	0.131	0.107	–
Revenue car-km operated	**32.55**	34.17	1.15	–
Safety performance (unit)				
Number of passengers & public injured	**36**	38	3	–
Passengers & public injured per million passengers carried	**0.55**	0.79	2.33	–

* *East Rail Tsim Sha Tsui Extension and Ma On Shan Rail commenced operation on 24 October 2004 and 21 December 2004 respectively.*
** *West Rail commenced operation on 20 December 2003.*

2001	2000	1999	1998	1997	1996
292	288	275	269	261	247
205	204	200	204	206	199
87	84	75	65	55	48
0.799	0.788	0.755	0.737	0.716	0.675
75.57	73.78	72.58	71.40	69.33	69.69
4,487	4,466	4,263	4,204	4,115	3,853
191	192	186	168	157	153
0.65	0.67	0.67	0.62	0.60	0.62
2.1	2.0	1.7	1.4	1.5	1.8
117	118	115	114	126	125
0.319	0.323	0.314	0.314	0.346	0.342
10.68	10.68	10.25	10.29	9.66	9.42
35	27	51	42	73	86
0.30	0.23	0.44	0.37	0.58	0.69
–	–	–	–	–	–
–	–	–	–	–	–
–	–	–	–	–	–
–	–	–	–	–	–
–	–	–	–	–	–

Ten-year Statistics

Operating (million)	**2005**	2004	2003	2002
Bus				
Total number of passengers*	**27**	20	26	26
Bus-km operated*	**6.29**	6.95	7.70	6.78
Safety performance (unit)				
Number of passengers & public injured	**8**	8	4	4
Passengers & public injured per million passengers carried	**0.18**	0.21	0.10	0.09
Freight				
Freight volume				
Southbound goods (tonnage)	**0.4**	0.5	0.6	0.7
Northbound goods (tonnage)	**0.2**	0.3	0.4	0.5
Livestock (head)	**0.1**	0.4	0.7	0.9
Employees at year end (number)				
Transport	**4,372**	4,227	3,914	3,228
Property	**111**	109	97	92
Capital Projects	**754**	867	1,211	1,557
Corporate & other services	**642**	671	649	633
	5,879	5,874	5,871	5,510

* *With effect from May 1999, the East Rail feeder bus services were operated by Kowloon Motor Bus Company (1933) Limited. Hence the number of passengers carried by these services and their bus-km operated have been excluded from KCRC's operating statistics.*

2001	2000	1999	1998	1997	1996
21	16	16	38	39	38
6.20	5.43	5.17	6.03	5.84	5.99
8	6	4	14	23	18
0.21	0.18	0.12	0.37	0.59	0.47
0.6	0.7	0.7	0.7	0.9	1.2
0.4	0.4	0.5	0.5	0.6	0.8
0.9	1.1	1.2	1.3	1.4	1.5
3,218	3,202	3,179	3,169	3,121	3,106
75	74	68	61	39	29
1,303	1,077	841	518	201	50
574	514	494	442	370	327
5,170	4,867	4,582	4,190	3,731	3,512

Banks and Financial Institutions

The following is a list of key relationship banks and financial institutions which provide services to the Corporation in respect of its financing, hedging, investment and cash management activities.

ABN AMRO Bank N.V.
American Express Bank Limited
Australia and New Zealand Banking Group Limited
Banca Intesa S.p.A.
Banco Bilbao Vizcaya Argentaria, S.A.
Bank of America, National Association
Bank of China (Hong Kong) Limited
Bank of Communications
Bank of East Asia, Limited, The
Bank of New York, The
Bank of Nova Scotia, The
Bank of Tokyo-Mitsubishi UFJ, Ltd., The*
Barclays Bank Plc.
Bayerische Hypo-und Vereinsbank Aktiengesellschaft
Bayerische Landesbank
BNP Paribas
Calyon
Canadian Imperial Bank of Commerce
Citibank, N. A.
Commerzbank AG
Commonwealth Bank of Australia
Credit Suisse**
Dah Sing Bank Limited
DBS Bank Ltd.
Deutsche Bank AG
DZ Bank AG Deutsche Zentral-Genossenschaftsbank
Export Development Canada
Fortis Bank
Fubon Bank (Hong Kong) Limited
HSH Nordbank AG
Hang Seng Bank Limited
HSBC
ING Bank N.V.
Japan Bank for International Cooperation
JPMorgan Chase Bank, National Association
KBC Bank N.V.
Lehman Brothers
Liu Chong Hing Bank Limited
Merrill Lynch & Co., Inc.
Mizuho Corporate Bank, Ltd.
Morgan Stanley
Nanyang Commercial Bank, Limited
National Australia Bank, Limited
Oversea-Chinese Banking Corporation Limited
Rabobank
Royal Bank of Scotland Plc, The
Sanpaolo IMI S.p.A.
Shanghai Commercial Bank Limited
Societe Generale
Standard Chartered Bank (Hong Kong) Limited
Sumitomo Mitsui Banking Corporation
Tai Fung Bank Limited
UBS AG
UniCredito Italiano S.p.A.
United Overseas Bank Limited
WestLB AG
Wing Hang Bank Limited
Wing Lung Bank Limited

* *Following the merger of The Bank of Tokyo-Mitsubishi, Ltd. and UFJ Bank Limited on 1 January 2006, the merged bank was named The Bank of Tokyo-Mitsubishi UFJ, Ltd.*

** *Effective 16 January 2006, the name of Credit Suisse First Boston was changed to Credit Suisse.*

List of Consultants

Name of Contract	Contract No.	Consultant	Division	Contract Amount (Lump Sum) (in HK$)
1. Detailed Design Consultancy Services for Expansion of Commercial Areas in Sha Tin Station and Citylink Plaza	PDD-SHT	Ma Leung & Associates (HK) Ltd.	Property	$21,298,000
2. Dynamics and Noise Consultancy Services for Kowloon Southern Link	KGS831	Harris Miller Miller & Hanson Inc.	Capital Projects	$10,031,600
3. Provision of Services to Support the Mediation Process of Contracts TCC200 and TCC300	TGSA-018	Maunsell Consultants Asia Ltd.	Capital Projects	$9,500,000
4. Design of Middle Road Subway Extension, Kowloon Southern Link	KDC101	Maunsell Consultants Asia Ltd.	Capital Projects	$8,800,000
5. Consultancy for Review of Contracts TCC200 and TCC300 Mediated Sums as Documented by MOUs	TGSA-022	Ernst & Young	Capital Projects	$6,900,000
6. West Rail Wetland Ecological Monitoring and Adaptive Management Services	TSA-026	Asia Ecological Consultants Ltd.	Capital Projects	$6,115,798
7. Ecological Monitoring and Technical Support for Wetland Compensation Area at Lok Ma Chau	LGSA-010	Asia Ecological Consultants Ltd.	Capital Projects	$5,168,232
8. Engineering Services for Wing On Plaza Garden PTI, Tsim Sha Tsui Extension	HDD301	Ove Arup & Partners Hong Kong Ltd.	Capital Projects	$4,300,000
9. Design and Construction Management Consultancy, Renovation of Tai Po Market Station	–	Leigh & Orange Ltd.	Transport	$3,280,000
10. Consultancy for the Study of Long Term Business Strategy for Light Rail Transit After Expiry of Transit Services Area Protection in October 2006	–	MVA Hong Kong Limited	Transport	$2,988,000

Glossary of Financial Terms and Further Information

Glossary of Financial Terms

Net current assets/liabilities
Net current assets/liabilities include stores and spares, interest and other receivables, cash and cash equivalents, interest and other payables, and accrued charges and provisions for capital projects.

Operating margin
Operating profit before depreciation and interest and finance income/expenses divided by turnover.

Return on equity
Net profit after taxation divided by the sum of share capital and reserves.

Revenue per employee excluding project staff
Turnover divided by the number of employees excluding project staff at the end of the year.

Debt/equity ratio
Total interest-bearing borrowings divided by the sum of share capital and reserves.

Debt to total capitalisation
Total interest-bearing borrowings expressed as a percentage of the sum of total interest-bearing borrowings and equity.

Interest cover
Operating profit before interest and finance income/expenses, depreciation and amortisation of interest in leasehold land, plus share of profit of associate and gross interest income before capitalisation divided by gross interest expenses before capitalisation.

Further Information

The Corporate Affairs Department will be pleased to supply any further information on request. Please contact:

Ms Rowena Li
Tel: (852) 2688 1360
Fax: (852) 2688 0394
Email: homepage@kcrc.com

Address of the Corporation's registered office and principal place of business:
KCRC House, 9 Lok King Street, Fo Tan, Sha Tin, Hong Kong.

This Annual Report is also available via: www.kcrc.com

DESIGN & PRODUCTION: THE DESIGN ASSOCIATES LTD. www.tda.com.hk PHOTOGRAPHY: ALFRED KO THIS ANNUAL REPORT IS PRINTED ON ENVIRONMENTALLY FRIENDLY, TOTALLY CHLORINE-FREE PAPER

Kowloon-Canton Railway Corporation
KCRC House, 9 Lok King Street, Fo Tan, Hong Kong