Kowloon-Canton Railway Corporation
Annual Report 2006

MEETING CHALLENGES PREPARING FOR CHANGE

KCR
九廣鐵路

KCRC: MEETING CHALLENGES, PREPARING FOR CHANGE

The year 2006 was one of both challenge and change.

During the year we faced the challenge of building ridership and met it by increasing patronage for all of our passenger services. We also met the crucial challenge of further expanding our rail network by completing the construction of the Lok Ma Chau Spur Line for opening by mid-2007, and starting works on the Kowloon Southern Link and the planning for the construction of the Northern Link and the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link. We dealt successfully with a technical problem that involved our East Rail trains but posed no risks to our passengers. To retain passengers' confidence in our services, we adopted a policy of total transparency as regards what actions were being taken.

During the year we also enhanced our services to ensure Hong Kong people can continue to enjoy a railway service that is consistently ranked among the world's best.

The year ahead could bring the most significant change in the Corporation's history, with the possibility of a merger of the rail systems of KCRC and the MTR Corporation. In anticipation of this possibility, we prepared our staff during the year for a smooth integration of the two systems should the merger be approved.

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CORPORATE PROFILE

The Kowloon-Canton Railway came into service in 1910 and has since played a central role in the life of Hong Kong. In 1982 the Kowloon-Canton Railway Corporation (KCRC) was established through the enactment of the Kowloon-Canton Railway Ordinance. In addition to providing high quality mass transport services in the Hong Kong Special Administrative Region, 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 public transport operators, carrying about 1.6 million passengers each day. 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 providing 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 domestic, 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.

ABOUT KCRC

KCR came into service in
1910

Incorporated in
1982

Total route length
113 KM

1.6 MILLION
passengers daily

6,049
employees

$5,622 MILLION
revenue in 2006

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

1. Lok Ma Chau Spur Line (opens in 2007)
2. Kowloon Southern Link (opens in 2009)
3. The Northern Link (under planning)
4. Shatin to Central Link (under planning)

KCR Network

ABOUT KCRC

Hong Kong's
ONLY RAIL LINK
with the Mainland

8,970 PASSENGERS
a day on through trains

Direct through train service to
6 MAINLAND CITIES

12 ROUND TRIPS
a day for Guangzhou-Kowloon Through Train

e-TICKETING
website for booking of through train tickets

KCR Mainland Connections

KEY FIGURES AND CREDIT RATINGS

FINANCIAL HIGHLIGHTS	2006 (HK$ million)	2005 (HK$ million)
Revenue from operations	**5,622**	5,383
Operating profit before depreciation and amortisation	**2,580**	2,356
Operating profit after depreciation and amortisation	**292**	98
Net profit after tax	**278**	317
Capital expenditure	**3,317**	3,835
Interest-bearing borrowings (HK$ million)	**19,212**	19,474
Debt/equity ratio	**1:3.1**	1:3.1
Interest cover (times)	**2.2**	1.9

CREDIT RATINGS	2006	2005
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**	AA-
Moody's		
Short-term issuer rating	**P-1**	P-1
Long-term local currency issuer rating	**Aa3**	Aa3
Long-term foreign currency issuer rating	**Aa3**	A1
Senior unsecured local currency debt rating	**Aa3**	Aa3
Senior unsecured foreign currency debt rating	**Aa3**	Aa3

OPERATING HIGHLIGHTS	2006	2005
Number of passengers (millions)		
East Rail (including Ma On Shan Rail)	**335**	325
Through Train	**3.3**	3.1
West Rail	**73**	65
Light Rail	**136**	136
Bus (excluding East Rail buses)	**30**	27
Freight volume (thousands)		
Southbound goods (tonnes)	**352**	375
Northbound goods (tonnes)	**228**	234
Livestock (heads)	**18**	129
Employees at year end (number)	**6,049**	5,879

SERVICE PUNCTUALITY*	2006 (%)	2005 (%)
East Rail Main Line	**99.82**	99.82
Ma On Shan Rail	**99.94**	99.92
West Rail	**99.88**	99.76
Light Rail	**99.92**	99.94

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

2006 SNAPSHOTS

JANUARY

Cracks investigation

The Corporation began investigating the cause of the cracks found in the welded supports of the underframe components of some East Rail trains. Short-term mitigation measures were put in place to ensure the safe operation of trains.

Sheung Shui Station improvement

A new Sheung Shui Station southern concourse was opened in preparation for the increase in patronage when the Lok Ma Chau Spur Line comes into service.

FEBRUARY

Planning go-ahead for NOL and ERL

The Executive Council gave the green light to commence further planning for the Northern Link and the Hong Kong section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link.

Visit by Chief Executive

On 4 February the Chief Executive of the Hong Kong SAR Government, Mr Donald Tsang, visited Ho Tung Lau Maintenance Centre.

Visit by Minister of Railways

China's Minister of Railways Mr Liu Zhijun led a delegation to Hong Kong between 26 and 28 February to study the development of Hong Kong's passenger and freight rail transport, infrastructure and facilities.

MARCH

KCRC named a Caring Organisation

After receiving the Caring Company award for three consecutive years, KCRC was named a Caring Organisation by the Hong Kong Council of Social Services, acknowledging the Corporation's contributions to the community.

Merger of the KCR and MTR systems announced

On 11 April the Government announced the structure and terms for the proposed merger of the KCR and MTR systems.

Phase II facelift for Lo Wu Station

The HK$50 million Phase II Improvement Works Programme for Lo Wu Station started in April 2006 and will be completed in early 2007.

KCRC's environmental efforts recognised

The Corporation received two awards for its environmental work, namely, the 2005 Hong Kong Awards for Industries: Environmental Performance Award and the Environmental Protection Department's Gold Wastewi$e Logo.

APRIL

New face of Ocean Walk

KCRC's shopping centre at Tuen Mun Ferry Pier Light Rail Terminus was renamed "Ocean Walk" and fully renovated to provide local residents with a more convenient and comfortable shopping environment.

Corporate website revamped

The revamped KCRC website (www.kcrc.com) features a new design with re-organised content and navigation.

Tender awarded for Tai Wai Maintenance Centre property development project

The tender for the joint venture property development above Tai Wai Maintenance Centre was awarded to a subsidiary of Cheung Kong (Holdings) Limited.

Ir James Blake takes over as CEO

Ir James Blake, former Senior Director, Capital Projects of the Corporation, returned to KCRC in March and officially took over the office of Chief Executive Officer on 1 May.

Cracks investigation report submitted

On May 3, a final report was submitted to the Government on the cause of the failure and cracking of underframe equipment support brackets on East Rail trains.

Chris Patten's visit to West Rail

On 23 July the former Hong Kong Governor Lord Christopher Patten visited West Rail accompanied by KCRC Chief Executive Officer Ir James Blake.

World first for KCRC fibre optic technology

KCRC was the first company in the world to apply advanced fibre optic technology to monitor railway system performance and wheel rail interaction stresses. With the adoption of this technology, abnormalities can be detected earlier and problems rectified before they become an issue.

MAY | JUNE | JULY | AUGUST

Tai Po Market Station Refurbishment Project

Work began on the HK$84 million Tai Po Market Station Refurbishment Project. Scheduled for completion by the end of 2007, the station will provide modern new facilities, wider passages and a greater variety of shops.

KSL tunnel boring commenced

On 16 August a ceremony was held to celebrate the launch of Xiaolongnu (Little Dragon Girl) — the 80-metre long tunnel boring machine (TBM) tailor-made for the Kowloon Southern Link. The TBM was adopted for the excavation of a tunnel from the junction between Canton Road and Austin Road to the Sheraton Hotel on Salisbury Road.

West Rail Tuen Mun Station property development project awarded

KCRC, acting as the agent of Tuen Mun Property Development Limited, awarded the tender to a subsidiary of Sun Hung Kai Properties Limited. The project is expected to be completed in 2013.

New facilities at Lo Wu

Station facilities under the Phase II improvement works at Lo Wu Station were partially opened for public service. The new facilities included a widened platform, additional variable speed control escalators, travellators on the platforms and innovative energy-saving fluorescent tubes.

KCRC in the spotlight

To chronicle the history and achievements of the Kowloon-Canton Railway since it came into operation in 1910, the Corporation published a book *KCR, Then and Now*. Net proceeds from the sale will be donated to the Lifeline Express, a hospital train serving needy eye patients in the Mainland.

A series of TV segments, entitled *KCRC Special: A Journey on the Railway*, was broadcast on TVB Jade, highlighting the work of KCRC's dedicated staff in providing a safe and reliable railway service.

SEPTEMBER OCTOBER NOVEMBER DECEMBER

Corporate Safety Month

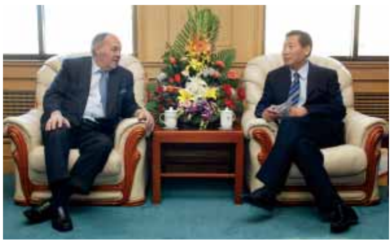
KCRC and the MTR Corporation co-hosted Corporate Safety Month 2006. This joint event featured a variety of activities aimed at enhancing the safety awareness of all staff and contractors under the theme Managing Risk and Safety: Our Key to Sustainability.

Pat Heung Maintenance Centre Open Day

To mark the third anniversary of West Rail, an Open Day at Pat Heung Maintenance Centre was organised. Visitors were able to learn more about the operations of the depot and the maintenance procedures of West Rail trains.

CEO visits the Ministry of Railways

Chief Executive Officer Ir James Blake met with Vice Minister of Railways Mr Hu Yadong on 5 December to exchange views on the development of the railway passenger and freight business between the Mainland and Hong Kong.



Intelligent Platform Extension System to be tested on East Rail

To provide a safer travelling environment for passengers, the Corporation announced that it would test a new Intelligent Platform Extension System on East Rail to minimise the risk of platform gap accidents. Lo Wu was chosen as the first testing site. If the test results are satisfactory, the Corporation will consider installing the system in other stations with curved platforms and wide gaps.

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 the Employees Retraining Board, Member of Education Commission, Manpower Development Committee and Guangdong Chinese People's Political Consultative Conference.

James Blake OBE, JP

CEng, Hon FHKIE, FHKEng, FICE, FIStructE, FIHT
Chief Executive Officer
Member of Capital Projects Committee
Member of Finance Committee
Member of Property Committee

Chief Executive Officer (Designate) from March 2006, prior to taking up the post on 1 May 2006. KCRC's Senior Director, Capital Projects 1997-2003, responsible for the Corporation's massive railway expansion programme. Currently a member of the Election Committee Engineering Sub-sector; Co-chairman, Corporate & Employee Contribution Programme of the Community Chest of Hong Kong; member, Construction Industry Council.

Samuel M H Lai

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

Appointed Chief Executive Officer (Acting) in 2004. Left the Corporation on 30 April 2006.

Vincent Lo Wing-sang BBS, JP

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

Appointed in 1999. Consultant of Messrs Gallant Y T Ho & Co, 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.

Patrick B Paul CBE

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

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.

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 Exchange Fund Advisory Committee, and Commission on Strategic Development of the Committee on Economic Development and Economic Cooperation with the Mainland. 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.

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.

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, See Corporation Ltd, Eagle Asset Management (CP) Ltd and ITC Corporation Limited. Independent Non-executive Director of Titan Petrochemicals Group Limited, Regal Portfolio Management Limited, Country Garden (Holdings) Company Limited and Hop Hing Holdings 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.

Wan Man-yee BBS, JP

FHKIS, FRICS, RPS (GP)
Board Member
Chairman of Capital Projects Committee
Member of Audit Committee

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

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 Court of Lingnan University. Hong Kong Deputy to the 10th National People's Congress, PRC.

MANAGEMENT COMMITTEE

Management Committee members in the concourse of the new Lok Ma Chau Station, overlooking Hong Kong's largest Ecological Enhancement Area

James Blake OBE, JP

CEng, Hon FHKIE, FHKEng, FICE, FIStructE, FIHT

Chief Executive Officer

Chief Executive Officer (Designate) from March 2006, prior to taking up the post on 1 May 2006. KCRC's Senior Director, Capital Projects 1997-2003, responsible for the Corporation's massive railway expansion programme. Secretary for Works, Hong Kong Government 1991-1995, co-ordinating the Airport and Public Works programme of major infrastructure developments. Consulting and contracting involvement with major projects in Hong Kong 1965-1990. President, 1991-1992, Hong Kong Institution of Engineers. Institution of Civil Engineers Gold Medal 1997. President, 1998-2000, Federation of Engineering Institutions of South East Asia Pacific. Member, 1999-2002, Construction Advisory Board. Currently a member of the Election Committee Engineering Sub-sector; Co-chairman, Corporate & Employee Contribution Programme of the Community Chest of Hong Kong; member, Construction Industry Council.

Y T Li

BSocSc, MPhil, FCHKPWS, CMILT, MIRSE (HON)

Senior Director-Transport

Joined KCRC in 1984. Appointed Senior Director-Transport in 2003. Vice Chairman of Asia-Pacific Division, International Association of Public Transport (UITP). Council Member of the Chartered Institute of Logistics & Transport in Hong Kong. Member of the Steering Committee on Principals' Professional Development, Users' Committee of the Immigration Department and the Transport & Logistics Services Council of the Federation of Hong Kong Industries.

K K Lee

BSc, MSc, MBA, EngD, 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 (till October 2006). Adjunct Professor in Electrical Engineering, Hong Kong Polytechnic University.

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. Member of the Public Service Commission since 2006.

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 Samuel M H Lai, Chief Executive Officer (Acting), left the Corporation on 30 April 2006.

SENIOR MANAGEMENT

James Blake

Chief Executive Officer

Transport Division

Y T Li

Senior Director-Transport

William Leung Hon-wai

General Manager-Rolling Stock (seconded to Merger Integration Office since May 2006)

Tsui Wai-keung

General Manager-West Rail Operations

Carmen Li Wai-ching

General Manager-Intercity & Freight

Anthony Yan Shiu-tseung

General Manager-East Rail Special Operations

Fung Wing-yiu

General Manager-Infrastructure & Buildings

Alok Jain

General Manager-Marketing

Selwyn Lai Sau-heem

General Manager-East Rail Operations

Tony Lee Kar-yun

General Manager-Rolling Stock

Alex Lau Hing-hon

Safety & Quality Manager

Capital Projects Division

K K Lee

Senior Director-Capital Projects

Lisa Seto Siu-wah

General Manager-Finance & Support

Stephen Chik Wai-keung

General Manager-Capital Works Planning

Joseph Choi Kin-hung

General Manager-Construction (East Rail Extensions & Kowloon Southern Link)

Tsui King-cheong

Project Manager-E&M Systems

Terence Law Che-chung

Project Manager-Rail Control Systems

Property Division

Daniel C Lam

Director-Property

Karen Wong Law Kwai-wah

General Manager-Property & Commercial Services

Alfred Yeung Kwong-fai

General Manager-Property Development

Geoffrey Wong King-lau

Chief Manager-Property Construction

Finance Division

Lawrence Li

Director-Finance

Jeffrey Cheung Hing

Deputy Director-Finance

Raymond Chan Wai-man

General Manager-Financial Control

Danny Tang Wah-hau

General Manager-Information Technology Services

Stanley Woo Kam-ming

General Manager-Internal Audit

Jimmy Leung Kwok-keung

General Manager-Procurement

Human Resource Division

Mimi Cunningham

Director-Human Resource

Katy Lam Kwun-yi

General Manager-Quality & Organisational Development

Company Secretariat and Legal Department

David Fleming

Company Secretary and General Counsel

Corporate Affairs Department

Raymond Wong King-hung

Senior Corporate Affairs Manager

Eva Law Weng-yee

Senior Corporate Communications Manager

KCRC SERVICES

EAST RAIL

46.5 kilometres in length with 22 stations

Hong Kong's main north-south mass transit public transportation artery

Hong Kong's only rail link with the Mainland

Two new extensions – the Tsim Sha Tsui Extension and Ma On Shan Rail – added in 2004

A third extension – the Lok Ma Chau Spur Line – to open in 2007

WEST RAIL

30.5 kilometres in length with 9 stations

Links the North West New Territories and urban Kowloon

An integrated transport network serving residents of the North West New Territories

LIGHT RAIL AND BUS

One of the world's largest light rail systems

Part of the integrated transport system of the North West New Territories

Restructured as a feeder service to West Rail to meet local transport needs

Feeder bus services operated in support of West Rail, East Rail and Light Rail

MAINLAND LINKS

Intercity passenger services operated between Guangzhou and Hong Kong on KCRC's own train

Access and terminal facilities also provided for other Mainland intercity trains running between Beijing, Shanghai and Guangzhou, as well as other major cities

Daily container, general cargo and livestock rail freight services operated between Hong Kong and the Mainland

CHAIRMAN'S STATEMENT

The theme of this year's Annual Report "Meeting Challenges, Preparing for Change" aptly describes what has been an eventful year. It is gratifying to be able to report therefore that the year as a whole ended well, with rail patronage and revenue up, and despite heavy depreciation charges from the new lines that have been constructed over the past 10 years, net profit was HK$278 million, similar to that of 2005.

CORPORATE GOVERNANCE

Since becoming Chairman in December 2001, I have stressed the continuing need to enhance corporate governance, and particularly the need to develop a culture of accountability and transparency throughout the Corporation. With the backing of the Managing Board and senior management, and the cooperation of staff, much has been accomplished.

A proactive approach is taken to public relations, especially when incidents occur. Rather than be placed on the defensive, we actively disseminate information about incidents and the action taken by the Corporation. This avoids misunderstandings and builds public confidence in the integrity of the Corporation and its staff.

An example is the 8-minute rule. Before the opening of West Rail and in particular the cracked rail incident at Kowloon Tong Station in December 2003, we only informed the public when an incident was likely to cause a delay in services of 20 minutes or more. In order to be more transparent and accountable to passengers, in early January 2004 we introduced what is commonly referred to as the 8-minute rule, whereby a report must be made to the public via the media of any incident which might cause a delay of 8 minutes or more in passengers' journey times. While this inevitably resulted in the reporting of more delays, the public has come to realise the benefit of receiving the earliest possible notification of an incident.

A further, more recent case arose in December 2005 when cracks were first found in the mountings supporting the underframe equipment below some of the Corporation's fleet of East Rail trains. During the investigation to identify the root cause, we decided to be totally transparent by keeping the public informed on a daily basis of the details of what had been discovered and the actions being taken in response. By this means I believe that we were able to retain the full trust of the public even though the root cause had not at that time been determined.

Moreover, when the Managing Board considered the findings and recommendations of a separate independent inquiry into communications arising from the incident, a decision was made to remind staff concerned that they should learn a lesson from the incident and that transparency brings with it accountability.

I remain committed to ensuring that the Corporation maintains the highest standards of accountability and transparency expected of a respected public organisation. I am confident that I have the full support of the Chief Executive Officer and his colleagues in this matter.

> “2006 was a milestone year for new railway projects. Ten years earlier, the Corporation took the first steps in undertaking a major expansion of its rail network, beginning with the planning and construction of West Rail.”

NEW RAILWAY PROJECTS

2006 was a milestone year for new railway projects. Ten years earlier, the Corporation took the first steps in undertaking a major expansion of its rail network, beginning with the planning and construction of West Rail. This was followed in quick succession by the extension of the Light Rail network to serve Tin Shui Wai and to integrate Light Rail services with those of West Rail; the construction of the three East Rail Extensions — Ma On Shan Rail, the Tsim Sha Tsui Extension and the Lok Ma Chau Spur Line — and, more recently, the construction of the Kowloon Southern Link and the initial feasibility studies for the Northern Link and the Express Rail Link.

The Lok Ma Chau Spur Line was completed to the stage of final commissioning during the year. We are now liaising with the Hong Kong Government and the Mainland authorities to ensure opening by mid-2007.

Good progress is being achieved in constructing the Kowloon Southern Link, and the project remains on track for commissioning in 2009. We await the Government's decision on the Shatin to Central Link. On 8 February 2006 the Government invited the Corporation to undertake further planning for the Northern Link and the Hong Kong Section of the Express Rail Link, both of which are priority rail projects for the years ahead. The MTR Corporation is being kept fully abreast of all new projects to ensure a smooth transition should the proposed merger take place.

THE MERGER

On 11 April 2006 the Government announced that it had signed a Memorandum of Understanding with the MTR Corporation Limited (MTRCL) setting out the terms under which the KCR and MTR systems would be merged. At this point in time, we can only prepare for but not assume a merger. The final decision depends on the passage of current draft legislation through the Legislative Council and approval by the minority shareholders of MTRCL.

The Managing Board is regularly briefed on the proposed merger-related activities, especially any that might impact on staff morale and service to the public. Out of some 6,000 KCRC staff, about 4,100 are frontline staff, who have already been given a guarantee of job security. In the case of non-frontline staff, a commitment has been announced whereby all employees will transfer to MergeCo on the Appointed Day on their prevailing terms and conditions. All staff have also been briefed on the salary protection principles, and major terms and conditions of employment that would apply to their transfer to MergeCo. In respect of the selection of individuals for positions in MergeCo, I am committed to ensuring that the selection process is fair and equitable and meets the reasonable expectations of staff.

MEMBERS OF THE MANAGING BOARD

The non-executive Membership of the Managing Board remained unchanged in 2006, with Members having had their terms of office extended into 2007. I would again take this opportunity to express my gratitude to my fellow Board Members for their positive support of the work of the Board and its Committees over the past 12 months.

MANAGEMENT AND STAFF

The Acting Chief Executive Officer, Mr Samuel Lai, tendered his resignation with effect from 30 April 2006. He was previously the Senior Director-Finance and Management before being appointed as the Acting CEO on 1 January 2004. Mr Lai's career with the Corporation spanned over 23 years, and his departure represented a considerable loss of corporate experience and knowledge.

"I also wish to use my statement to express more formally my heartfelt appreciation for the work and efforts made by all staff of the Corporation during 2006. It has not been an easy year for them."

Mr James Blake was appointed as the Chief Executive Officer with effect from 1 May. Mr Blake is well known to the Board, staff and many in the community. He was the Senior Director responsible for managing the Corporation's major new railway projects until 2004. In addition to his intimate knowledge of the Corporation, Mr Blake brings a wealth of management and project experience, having formerly been the Secretary for Works in the Hong Kong Government. Mr Blake has admirably demonstrated his talents since his appointment, especially given the challenges faced by the Corporation during 2006 since his arrival.

I also wish to use my statement to express more formally my heartfelt appreciation for the work and efforts made by all staff of the Corporation during 2006. It has not been an easy year for them. Not only have many had to put in long hours to deal with operation-critical situations like the cracks first found in the underframe equipment mountings of mid-life refurbished East Rail trains in late December 2005, they have also had to contribute additional time and knowledge to the many working groups that have been set up between the two railway corporations to prepare for the possible merger. That they have done so with enthusiasm, despite the uncertainties that inevitably arise with the Corporation not being a party to the detailed merger transaction negotiations, speaks well for their professionalism.

THE YEAR AHEAD

2007 can be expected to be a year of significant challenges. I and my colleagues on the Board remain confident, however, that management — indeed all staff — will continue to work hard to boost patronage, particularly on the new Lok Ma Chau Spur Line.

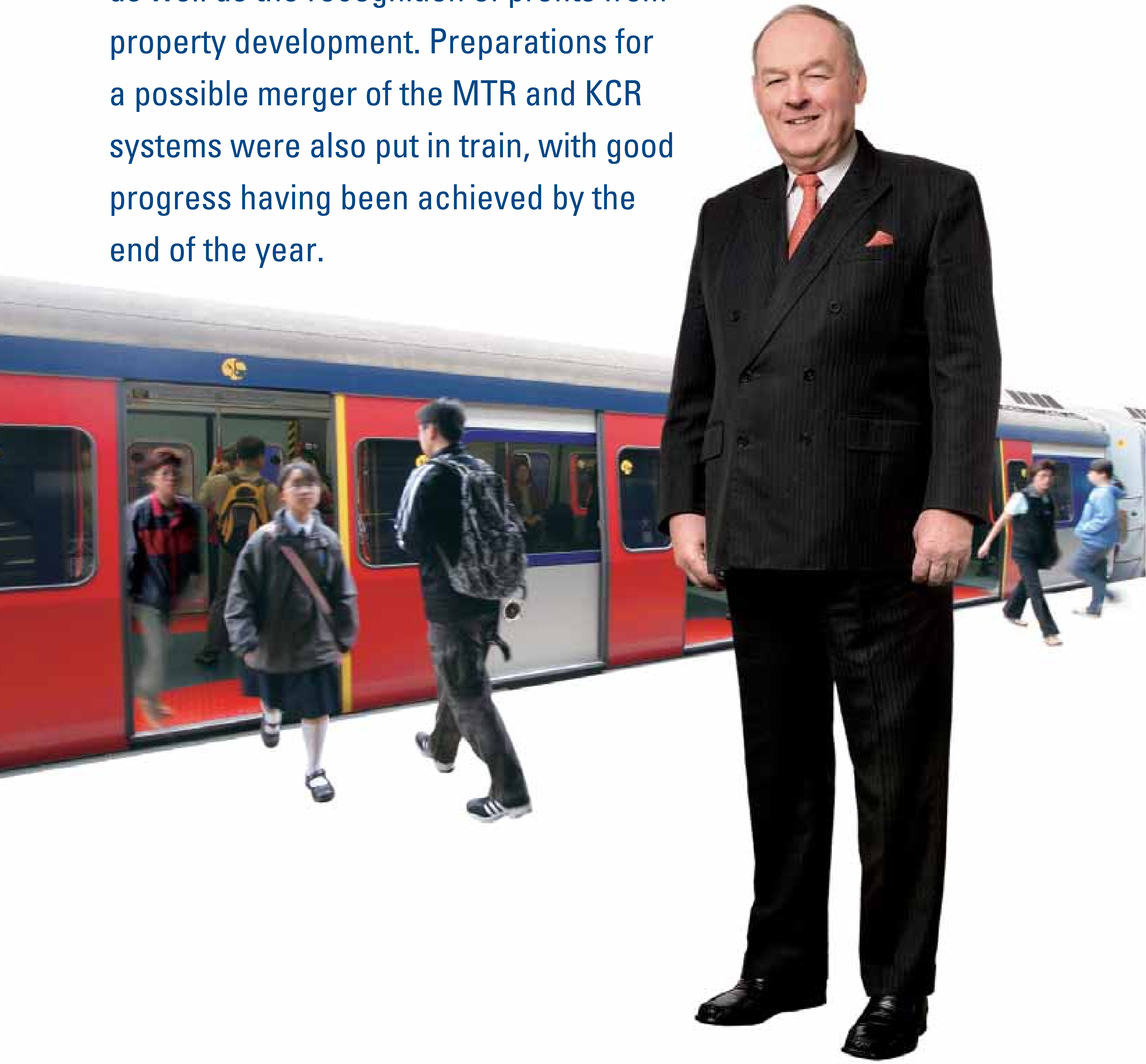
With the proposed merger coming ever closer and pressure to further enhance rail links with the Mainland, our major challenge will be to ensure that our services to the community at large continue at the highest levels of performance and provide the greatest value for money.

"Challenges are what make life interesting; overcoming them is what makes life meaningful." (Joshua J. Marine)

Michael Tien
Chairman
26 February 2007

STATEMENT OF THE CHIEF EXECUTIVE OFFICER

2006 again saw an increase in patronage and operating profit before depreciation as well as the recognition of profits from property development. Preparations for a possible merger of the MTR and KCR systems were also put in train, with good progress having been achieved by the end of the year.



TRANSPORT OPERATIONS

I am pleased to report that patronage continued to rise and operating costs are being kept under tight control during the year. In 2006 the Corporation took 16.4% of the domestic public transport market, up 0.3% from 2005. Moreover, whilst the franchised public transport market as a whole grew only by some 1.7% in 2006, the Corporation's patronage grew by 3.7%.

East Rail together with the Ma On Shan and Tsim Sha Tsui extensions saw domestic patronage grow by 3.2%, reaching over 700,000 per day in the last months of the year. This strong result reflects the popularity of our services, which serve a long-established catchment and fairly stable population. Ma On Shan Rail usage alone grew to 120,000 per day, representing an increase of 17.8% over 2005.

Since its opening in December 2003, West Rail has become the backbone of the Corporation's transport services in the Transit Service Area embracing the Tuen Mun, Yuen Long and Tin Shui Wai new towns. West Rail performed well in 2006, showing a healthy growth of patronage and revenue. Average daily patronage increased by 11.7%, resulting in excess of 200,000 passenger trips per day. In three years of service, West Rail patronage has grown by 100% from the number at opening.

> "Moreover, whilst the franchised public transport market as a whole grew only by some 1.7% in 2006, the Corporation's patronage grew by 3.7%."

Average daily patronage over the Transit Service Area increased by some 3.1%, with Light Rail patronage being supplemented by increased patronage on West Rail and KCRC buses. Light Rail and KCRC bus services provide an increasingly popular service for local travel journeys within the new towns and convenient feeder services to West Rail stations for onward longer distance travel between towns or to the urban area. Very heavy peak demand at some locations is being addressed by route improvements intended to maximise the whole design capacity of the available light rail fleet.

AVERAGE DAILY RIDERSHIP

(passenger trips)	**2006**	2005	% Increase
East Rail domestic service* (including Ma On Shan Rail)	**677,000**	656,200	3.2%
East Rail cross-boundary service* (to Lo Wu)	**241,000**	235,500	2.3%
Intercity Through Train service	**8,970**	8,520	5.3%
West Rail service	**200,100**	179,200	11.7%
Light Rail service	**373,800**	373,000	0.2%
Bus service (excluding East Rail buses)	**82,400**	74,600	10.5%
Total average daily passenger trips	**1,583,270**	1,527,020	3.7%

* *Average daily Ma On Shan Rail usage in 2006 was 119,800, which included passengers travelling within Ma On Shan Rail and passengers travelling between Ma On Shan Rail and all other stations including Lo Wu.*

Operating what in large part is a new railway system, depreciation will inevitably continue to have a substantial impact on the bottom line for a number of years to come. The heavy upfront capital expenditure required to provide the infrastructure necessary to handle forecast passenger numbers over the next 50 to 100 years is justified by passenger growth, but this growth does not come overnight. Several years must pass before passenger numbers on any new line are such that the fare revenue exceeds both the operating and depreciation costs. In the interim, cross-subsidy is necessary from the revenue obtained from the operation of older lines and other business activities.

Basic fares have not changed over the past decade. The West Rail and East Rail promotional monthly passes have attracted new rail users, but promotional schemes are often revenue neutral. On the part of Freight Services, following phasing out of the freight forwarding business, we have held onto other existing business and improved in some areas despite a very competitive market.

“Revenue from the Corporation’s non-transport activities, excluding that from property development, grew by 13.6% in 2006 to HK$876 million.”

Nevertheless, the Corporation depends very heavily on the revenue obtained from cross-boundary services to cross-subsidise new lines. Despite the land-based cross-boundary market having grown in patronage terms by some 5% over the year, rail passengers only increased by about 2.3%, with competing modes of road transport taking the major share of the growth. The Corporation must preserve its cross-boundary revenues, if the current level of domestic fares is to be protected.

CROSS-BOUNDARY (LO WU) AVERAGE DAILY PASSENGER TRIPS

	Passenger trips	% Increase / (Decrease)
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
2006	241,000	2.3

NON-TRANSPORT COMMERCIAL OPERATIONS

The challenge facing the Corporation, if it is to maintain its long-term profitability, is to generate additional revenue from non-rail business activities, especially the leasing of retail and advertising spaces in the stations and other commercial properties owned by the Corporation.

Revenue from the Corporation’s non-transport activities, excluding that from property development, grew by 13.6% in 2006 to HK$876 million. Whilst growth was generally achieved overall, the main contribution came from the rental of shopping centres, which benefited from the reopening in early 2006 of Ocean Walk in Tuen Mun following renovation, and the outstanding performance of the Duty Free Business.

Revenue from leasing commercial space and that from other advertising activities represents only about 16% of the Corporation's total revenue. With other non-transport revenue from property developments, the Corporation can maintain its profitable status in the immediate future. Over the longer term, the Corporation must continue to rely on its traditional transport and commercial business activities, and take advantage where possible to grow those businesses so as to secure increasing revenues.

PROPERTY DEVELOPMENT

During the year the Corporation awarded two further joint venture tenders for major residential projects, one along East Rail at Tai Wai Maintenance Centre and, as the agent for the HKSAR Government, a second above Tuen Mun Station along West Rail. Expressions of interest were also invited from local property developers to undertake development of a further West Rail site — Tsuen Wan West 7 — planned to be awarded as a joint venture during 2007. The joint ventures at Ho Tung Lau and Wu Kai Sha continued to show good progress. The Corporation now has in hand joint ventures for five major residential developments, which will bring onto the market a total of some 11,730 flats situated to allow their residents to take advantage of convenient travel by rail. These developments are expected to bring significant additional patronage to the rail network.

SUSTAINABILITY

Operating a railway is not simply a matter of satisfying the demand for public transport. We also have a duty to the community to ensure that our many activities are sustainable and meet the needs of the present without compromising the ability of future generations to meet their needs. In our everyday work, we face the challenge of having to take a holistic view of our business and the world in which we live.

> "KCRC has established a strong reputation for environmental protection, which was reinforced in the year when we obtained ISO 14001:2004 certification for our Capital Projects Division."

KCRC has established a strong reputation for environmental protection, which was reinforced in the year when we obtained ISO 14001:2004 certification for our Capital Projects Division. As part of our railway network expansion, we have made major investments in order to both protect and enhance the environment. In the case of the Lok Ma Chau Spur Line, we adopted special tunnelling methods to avoid disturbing the environmentally-sensitive Long Valley, and created and enhanced 37 hectares of wetland. Not only have we protected some 200 existing local species of birds, our wetlands have attracted visits by rare species not hitherto seen in Hong Kong, such as the Greater White-fronted Goose.

At an operational level, we operate the latest electrically-driven trains which incorporate the most modern energy saving and energy regeneration systems. With the special noise reduction measures that we have taken both on trains and along the network, we now operate what is perhaps one of the quietest railways in the world, and we still aim to do more. In December we signed a contract for the supply of nine new double-deck and 11 single-deck buses. In so doing, we became the first bus operator in Asia to purchase buses meeting the latest Euro IV emission standards.

Even at a non-operational level we seek to reduce our impact on the environment and to reduce the use of scarce resources. In recognition of this, we were awarded the Environmental Protection Department's Gold Wastewi$e logo in 2006 for reducing waste.

We also understand that achieving sustainability means involving others. An example of this is our Public Consultation Group, which comprises representatives of the Traffic and Transport Committees of the District Councils and of our passenger groups, and is chaired by Mr Vincent Lo, a non-executive Member of our Managing Board. We use this forum not only to explain our plans and activities but also to obtain comments and feedback on where we can best meet the needs of the community both in the short and long term.

FINANCIAL RESULTS

The Corporation's operational results for 2006 were very healthy, with total revenue increasing by 4.4% to HK$5,622 million, whilst operating costs before depreciation and amortisation increased only marginally by 0.5% to HK$3,042 million despite the impact of general inflation. Earnings before interest, tax, depreciation and amortisation increased from HK$2,356 million in 2005 to HK$2,580 million in 2006, which can be attributed to the 3.7% overall growth in patronage on the Corporation's rail and bus network and increased non-transport revenues.

> "The day-to-day challenges of ensuring passenger safety, efficiency of services, planning and completing capital projects on time and within budget, and boosting patronage and revenue on new lines will continue to be the primary focus of management."

After the recognition of property development profits and the share of profit of associates, and deducting the depreciation, amortisation and net interest and finance expenses, a profit of HK$430 million was recorded — a substantial improvement from a loss of HK$185 million recorded last year. However, after recognising the unrealised accounting losses on changes in the fair value of the Corporation's financial instruments and the valuation gains on investment properties, and deducting tax as explained in the Income Statement, the net profit for 2006 was HK$278 million, slightly down on the previous year.

LOOKING AHEAD

The year 2007 brings with it the proposed merger and the accompanying extra effort required of management to ensure a smooth transition up to the merger Appointed Day. Our business prospects are, however, soundly based, and our contribution to meeting Hong Kong's growing transport needs will be ensured by way of operating at the very highest international standards. The day-to-day challenges of ensuring passenger safety, efficiency of services, planning and completing capital projects on time and within budget, and boosting patronage and revenue on new lines will continue to be the primary focus of management.

Further ahead is the strong emphasis that the Mainland is placing on railway development, both at national and regional level, which inevitably will reflect favourably on the Corporation's future business prospects.

Even though the merger is still a proposed event, advantage has already been gained by way of the relations that have been established with our colleagues in the MTR Corporation. I remain confident, therefore, that during the year 2007 our passengers will continue to be served by an efficient and highly effective rail and bus transport network.

A THANK YOU TO STAFF

Running a modern-day multi-modal railway operation involving mass-transit, cross-boundary, intercity, bus and freight services as well as a wide range of non-transport business activities, such as property development and leasing of commercial and advertising space, depends entirely upon the dedication of our staff. Nearly 1.6 million passengers a day (over half a billion per year) depend on the Corporation's rail and bus network to provide them with a fast, convenient and efficient means of travel for both work and leisure activities. In 2006 the Corporation's train punctuality for all lines was well above 99.8%, placing it amongst the top railways in the world. While our technology is equal to the best in the world, this is only part of the reason: people rather than technology are often what count. I would therefore express my personal thanks to colleagues and all staff for the excellent performance achieved in 2006 despite the challenges that are now behind us.

James Blake
Chief Executive Officer
26 February 2007

TRANSPORT

574 MILLION
passenger trips in 2006

3.3 MILLION
Through Train passenger trips in 2006

677,000 PASSENGERS
a day – East Rail domestic

241,000 PASSENGERS
a day – East Rail cross-boundary

200,100 PASSENGERS
a day on West Rail

373,800 PASSENGERS
a day on Light Rail

82,400 RIDES
on our buses each day

ON TIME
99.82% East Rail

ON TIME
99.94%
Ma On Shan Rail

ON TIME
99.88% West Rail

TRANSPORT

KCRC operates a world-class passenger railway, which has served the people of Hong Kong for 96 years. As with the staff in other divisions, the staff of the Transport Division are meeting new challenges and preparing for the changes that lie ahead.

Domestic and Cross-boundary Services

The year was one of remarkable performance for the domestic services provided by East Rail and West Rail. Overall patronage grew 3.7% over the previous year, which was double the rate of the growth in transport market as a whole. We also continued to improve our railways and stations, while maintaining a safe, reliable and punctual service for passengers.

A safe and reliable service made possible by KCRC's dedicated staff

MORE PASSENGERS RIDING OUR RAILWAYS

During the year we substantially increased patronage and revenue for our domestic and cross-boundary railways.

Average patronage on East Rail reached 677,000 passengers a day, an increase of 3.2% from 2005. For Ma On Shan Rail, daily usage grew by 17.8%, and the Tsim Sha Tsui Extension by 10.7%.

As a result, East Rail's share of the domestic market was 37.6% for intra-New Territories travel, and 47% for travel between the New Territories and urban areas, which was 1.4 % and 0.4% higher compared with 2005 respectively.

West Rail also enjoyed satisfactory growth in patronage during the year, having passed the 200,000 daily patronage mark. This represented an increase of 11.7% over the previous year.

Cross-boundary patronage increased to an average of 241,000 a day during 2006, up 2.3% from 2005. However, due to demographic shifts to the western part of Shenzhen and increased competition from cross-boundary buses, our share of the cross-boundary land travel market dropped slightly from 63.1% in 2005 to 61.5% in 2006.

Revenue from all transport services increased appreciably during the year. This was mainly the result of the growth of the cross-boundary market, as well as the continuous build up in patronage on the Tsim Sha Tsui Extension, Ma On Shan Rail and West Rail.

OUR SERVICES CONTINUING TO IMPROVE

We pride ourselves on providing quality service to our customers. In 2006 we undertook or completed several improvement projects.

At Sheung Shui Station, we extended the concourse to increase passenger-handling capacity in preparation for the opening of the Lok Ma Chau Spur Line in 2007. Also at Sheung Shui, we began constructing noise barriers along the line, which will reduce the impact of train noise on nearby residents.

We also started remodelling works at Hung Hom Station in preparation for its new role in 2009 as the interchange for East Rail and West Rail. Track works and the planning for the construction of interchange facilities were both well underway.

The Tai Po Market Station Refurbishment Project was another station improvement project begun during the year. This project will be completed in 2007.

AT A GLANCE

	East Rail	Ma On Shan Rail	West Rail
Route length (km)	35.1	11.4	30.5
Number of stations	14	8*	9
Number of rail cars	444	72	154
Daily hours of operation	19.5	19.5	19
Daily number of train trips	544	494	407
Minimum headway (minutes)			
Peak hours	2.5	3	3.5
Off peak hours	5	5	6
Average daily ridership in 2006			
Domestic	677,000+		200,100
Lo Wu	241,000		
Highest daily ridership in 2006			
23 December	1,130,558+		
22 December			244,677

* excluding Tai Wai Station
+ including Ma On Shan Rail

Public areas monitored at all times to ensure the highest quality service

Phase II of the Lo Wu Station improvement project made good progress in 2006. We further expanded and renovated the station platforms and installed new escalators and travellators. With an expected completion date in the first quarter of 2007, the upgraded station will be able to handle 25,000 passengers per hour per direction compared with the existing 22,000, and help us maintain our competitiveness in the cross-boundary market.

In 2006 we made a number of improvements to ensure passenger safety. At East Rail's Beacon Hill Tunnel, we began work on a new ventilation system as a fire safety measure. More than 90% of the works were completed by the end of 2006, and the project was scheduled for completion in early 2007.

In December we announced a programme of introducing an Intelligent Platform Extension System on East Rail, initially at Lo Wu Station. This system will reduce the gap between East Rail trains and curved platforms at certain stations, thereby lowering the risk of accidents to passengers. If it is proved to be successful and well received by passengers, it will be installed in other stations with curved platforms and wide platform gaps.

We carried out major upgrades to the West Rail signalling system to ensure greater reliability and improve our handling of incidents. These included improvements to the power supply and earthing equipment as well as the signalling equipment software on trains. As a result, the number of delays exceeding eight minutes has been greatly reduced from 26 in 2005 to 13 in 2006.

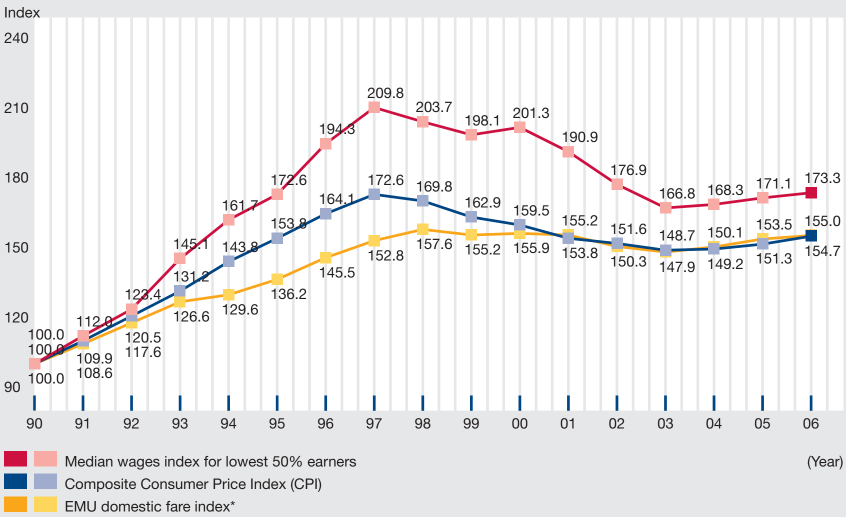
SERVICE PERFORMANCE

	East Rail		Ma On Shan Rail		West Rail	
	2005	2006	2005	2006	2005	2006
Service delivery*	99.84%	**99.85%**	99.94%	**99.95%**	99.82%	**99.91%**
Punctuality*	99.82%	**99.82%**	99.92%	**99.94%**	99.76%	**99.88%**
Availability of ticket vending machines*	99.56%	**99.60%**	99.83%	**99.82%**	99.88%	**99.93%**
Availability of Octopus equipment*	99.93%	**99.90%**	99.92%	**99.91%**	99.95%	**99.97%**
Reliability : million car-km per failure	0.81	**0.87**	0.87	**2.69**	1.91	**2.70**

* *2006 service targets – 99.0%*

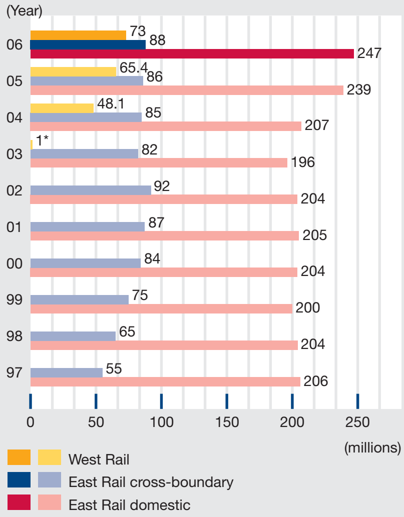
Quality customer service – a high priority for KCRC

FARES RELATIVE TO INCOME AND INFLATION



* Include East Rail domestic and West Rail

DOMESTIC AND CROSS-BOUNDARY PATRONAGE



* West Rail was officially launched on 20 Dec 2003
Patronage is reported for the period 20-31 Dec 2003

To further improve the reliability of West Rail operations, a second dedicated 11kV power supply for the Operations Control Centre and the Computer Centre at the West Rail Building was substantially completed for commissioning in early 2007.

Improvement works were also carried out at West Rail stations. We enhanced station signs and installed additional seats at platforms, handrails on wide staircases and canopies at Tuen Mun and Tsuen Wan West stations. We also built rain shelters at the entrances of Tin Shui Wai and Tuen Mun stations for the convenience of our passengers.

INNOVATIVE PROMOTIONS ATTRACT PASSENGERS

During the year we introduced seven new interchange discount routes with Green Mini-buses (GMB) and residential coaches to improve connectivity and the value of KCR journeys. We also extended the current monthly East Rail One-Month Pass.

A wide range of travel-related products was offered to stimulate leisure travel on KCR trains. Most travel packages came with either a Lo Wu 2-ride travel pass or domestic one-day travel pass. These included packages for Ocean Park and Macau.

Other promotions were made available in conjunction with the Hong Kong Tourism Board for discounts on selected KCR travel products for Mainland and overseas tourists.

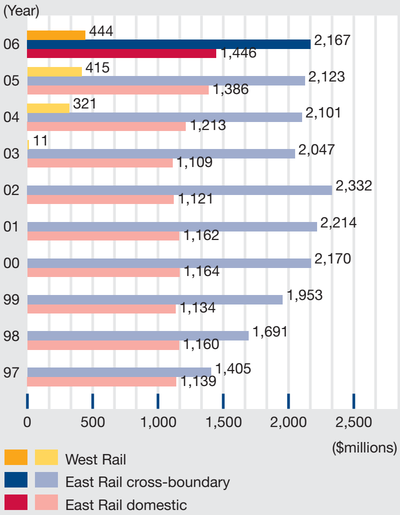
To increase patronage on West Rail, we extended the One-Month Pass and the one-day West Rail Discovery Pass, as well as the $2 weekend concessionary fares for children and senior citizens. The $2 West Rail fare rebate for passengers transferring from taxis to West Rail at designated stations was also extended. Moreover, we continued the interchange discounts for West Rail passengers travelling on some GMB routes and franchised buses.

A NEW STANDARD SET IN RAILWAY MAINTENANCE

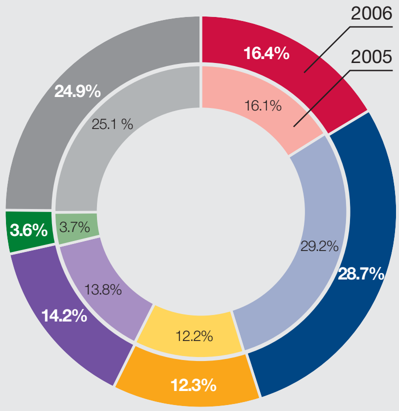
KCRC faced a tremendous challenge during the year after we had discovered that a compressor underneath an East Rail train had become loosened. This had occurred because of the formation of cracks in the welds of brackets holding the compressor to the train, which caused two of the three brackets holding the compressor to give way. No damage was caused to the compressor itself and passenger safety was not compromised.

Our investigation eventually revealed that the cracks were formed by excessive vibration generated by a vertical difference

DOMESTIC AND CROSS-BOUNDARY REVENUE



MARKET SHARE OF MAJOR FRANCHISED PUBLIC TRANSPORT MODES



Remarks:

1. Trams & Ferries includes HongKong Tramways, New World Ferry & Star Ferry
2. Other Buses includes New World First Bus, Citybus, Long Win & New Lantao Bus
3. KCR includes East Rail, Ma On Shan Rail, West Rail, Light Rail and KCR feeder buses

Source: Transport Department – Traffic and Transport Digest

of less than 1mm over a three-metre length in some rails along East Rail when trains travelled between 70kph and 90kph.

This was the first time in railway history for an incident of this type. To ensure it is not repeated, we started replacing the affected sections of rail, improving the train cars' suspension system to dampen vibrations, and strengthening the brackets holding components to the underframe of our trains.

We have also installed monitoring equipment on the tracks using a fibre optic system developed in cooperation with the Hong Kong Polytechnic University. The application of fibre optics on rails has never before been used in this way, and we have since applied for a patent for this innovative technology.

A number of KCR stations are being upgraded to provide better service

AT A GLANCE

	Light Rail
Route length (km)	36.2
Number of stops	68
Daily hours of operation	19
Minimum headway (minutes) Peak hours Off peak hours	 1.6 2.2
Average daily ridership	373,800
Highest daily ridership in 2006 (6 October)	479,370

	Bus
Number of buses	143
Total number of bus routes	14
Daily hours of operation	19
Minimum headway (minutes)	4
Average daily ridership (West Rail feeder buses in Transit Service area only)	82,400

SERVICE PERFORMANCE

	Light Rail		Bus	
	2005	**2006**	2005	**2006**
Service delivery*	99.96%	**99.98%**	99.75%	**99.90%**
Punctuality*	99.94%	**99.92%**	–	**–**
Availability of ticket vending machines*	99.89%	**99.91%**	–	**–**
Availability of Octopus equipment*	99.96%	**99.97%**	–	**–**
Reliability : million car-km / number of trips per failure	0.173 million car-km	**0.197 million car-km**	3,320 trips	**3,060 trips**

* *2006 service targets – 99.0%*

Light Rail and Bus

LIGHT RAIL SERVING PASSENGERS' CHANGING NEEDS

An important element of the Corporation's integrated transport system in the North West New Territories, the Light Rail network has assumed greater importance as a complementary service for West Rail. In 2006 patronage increased to an average of 373,800 passenger trips per day.

During the year we made several enhancements to Light Rail services to support its new role. For instance, we could see that with the opening of West Rail, Light Rail patronage on long haul routes had dropped as passengers began taking Light Rail to West Rail stations for travel between the new towns. We therefore introduced a service improvement scheme in October to deploy some of our resources from the long haul Light Rail routes to the local Light Rail routes.

Accordingly, we "turned short" one long haul route from Tin Shui Wai North to Yuen Long by merging two routes — the 761 and 761P. We also cancelled one bus route to allow the resources saved to be allocated to two other routes.

Beyond these measures, we commissioned a new Passenger Information System for Light Rail and installed new Passenger Information Display Units in the West Rail Siu Hong and Tin Shui Wai station concourses for passengers interchanging to Light Rail.

For the convenience of wheelchair passengers, we relocated and lowered 44 Platform Contactless Smartcard Processors (PCPs) on 22 platforms at 12 stops. In addition, we improved the Light Rail platform environment by installing benches, stop signs and passenger notices.

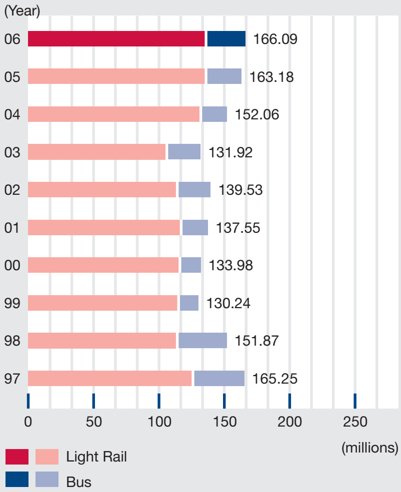
The Light Rail Operation Control Centre was expanded in 2006 to accommodate a modern control panel and Fault Reporting Centre. In addition, we completed the signalling system upgrade for Light Rail in mid-2006, which resulted in a tremendous improvement in the reliability of the system.

IMPROVED BUS SERVICES

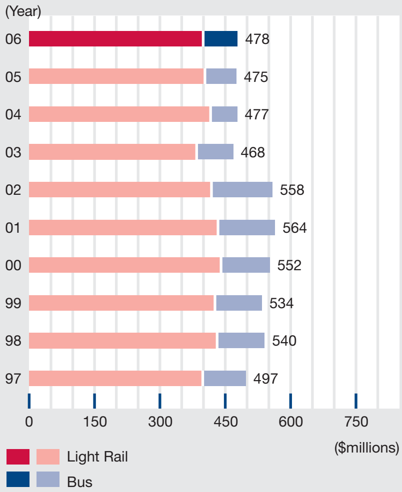
In 2006 there was a considerable increase in bus ridership compared with 2005, rising by 10.5% from 74,600 to 82,400.

Throughout the year, bus operation costs increased substantially mainly owing to the historically high fuel costs in the first half of 2006. KCRC will continue to implement cost control measures wherever practicable.

LIGHT RAIL AND BUS PATRONAGE



LIGHT RAIL AND BUS REVENUE



Nine new environmentally-friendly double-deck buses (the Alexander Dennis Trident Enviro 500) and eleven more single-deck buses (the Alexander Dennis Dart Enviro 200) will be delivered to Hong Kong in 2007 and 2008 to replace buses which will be retired in the next two years. Purchased at a cost of HK$55 million, the buses provide the highest level of passenger comfort while meeting the strictest environmental and safety standards. KCRC is the first transport company in Hong Kong to introduce buses fitted with the Euro IV engine and meet the latest legislative requirements passed in October 2006.

New environmentally-friendly buses will provide comfort for passengers, while meeting the highest safety standards

AT A GLANCE

Mainland Links	
Intercity Passenger Services	
Destinations (number of Mainland cities)	6
Average daily passengers	8,970
Freight in 2006	
Containers (TEUs)	13,773
Breakbulk (wagons)	3,303
Livestock (wagons)	152

The GZTT is gaining market share with new service enhancements and marketing programmes

Mainland Links

INTERCITY PATRONAGE GROWING STEADILY

Since increasing the Guangzhou-Kowloon Through Train (GZTT) service to 12 pairs daily from April 2004 (with three pairs operated by the Corporation with its own trains), patronage on the GZTT has been growing steadily. In large part, this has been due to the flourishing economy in the Pearl River Delta, which has driven the demand for cross-boundary transport.

Daily patronage in 2006 averaged 8,970, up 5.3% from last year. On 16 April a new record for daily GZTT patronage was recorded of 12,461 passengers, which stood for six months before being overtaken by another new record of 12,741 on 27 October. These two records were set during the 99th & 100th Chinese Export Commodities Fair at Guangzhou in April and October.

Market share for the GZTT increased by 0.9% to 24.9%, which can be attributed to the continuous service enhancements and marketing programmes initiated for through train services.

In 2006 the scope of the Individual Visit Scheme in the Mainland was further extended to cover six more cities (Nanchang, Changsha, Nanning, Haikou, Guiyang and Kunming). To tap the full potential of this market, the Corporation partnered with business associates for providing special offers to Mainland travellers coming to Hong Kong by GZTT.

Other joint promotions included offers on hotel packages and entertainment attractions as well as discounts provided by certain retailers.

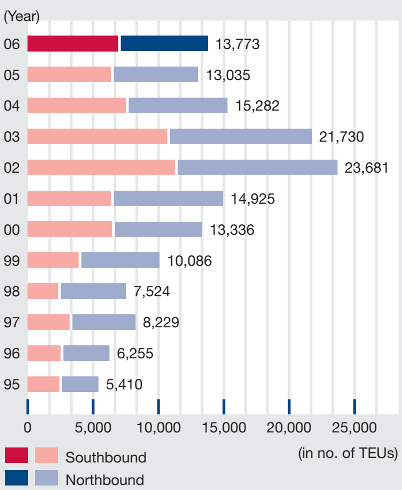
In the years ahead, there will be further opportunities in both the medium term and long term as more individual travellers are permitted to travel outside the Mainland. For increasing patronage, we can also look forward to the further extension of the new exhibition centre at Pazhou in Guangzhou, as well as the holding of the 2008 Olympic Games' equestrian events in Hong Kong, the staging of the East Asian Games in Hong Kong in 2009 and the Asian Games in Guangzhou in 2010.

To meet the growing demand, the Corporation will explore the possibility of increasing the frequency of the GZTT and opening new routes to other Mainland cities.

FREIGHT CONTINUING TO PROVIDE AWARD-WINNING SERVICE

In 2006 the Corporation was once again named the Best Rail Operator – Asia in the Asian Freight & Supply Chain Awards 2006. Voting in the

CONTAINER TRAFFIC



awards competition was by freight industry professionals across Asia.

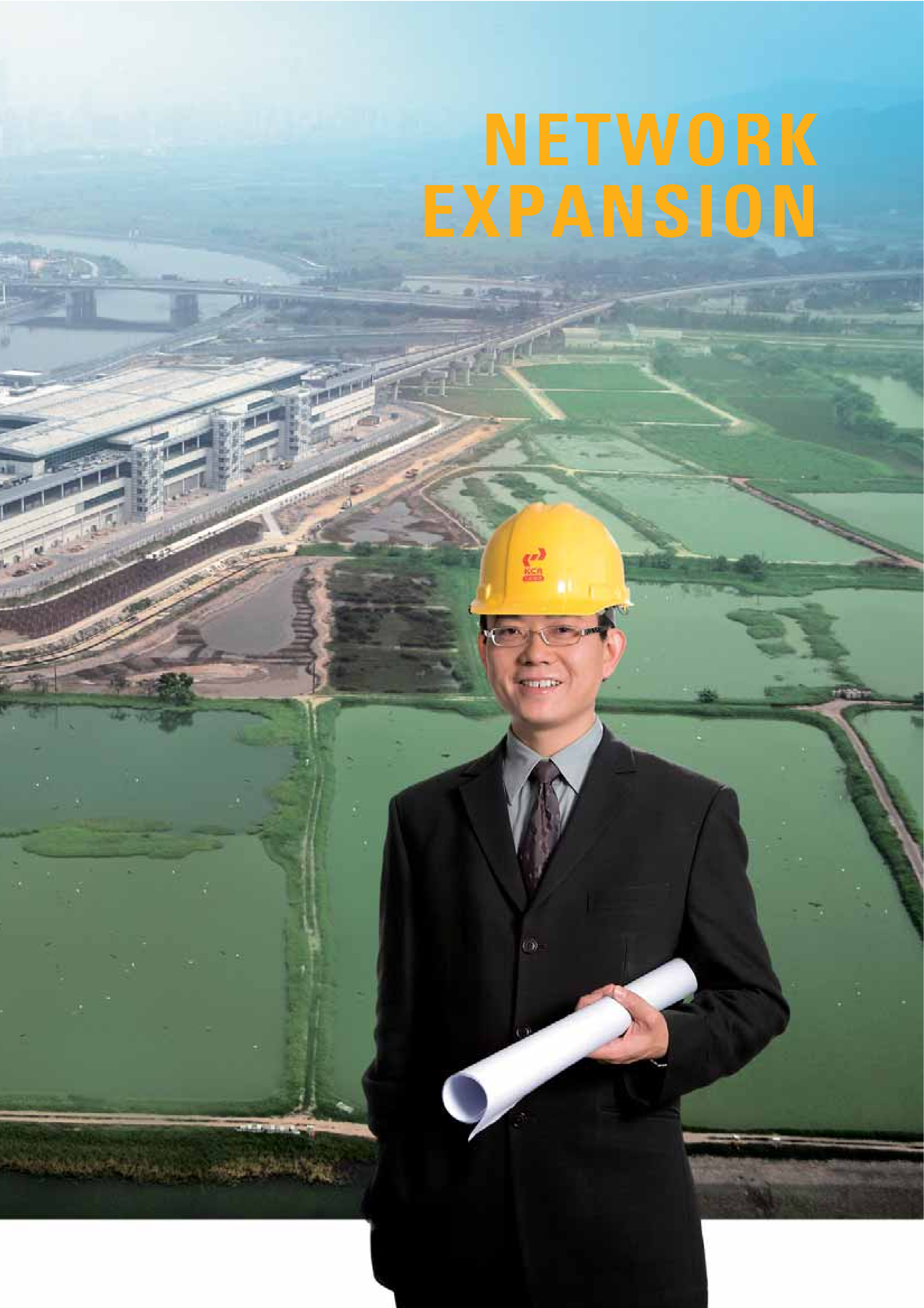
Despite recognition of its service quality, freight revenue decreased by 15.4% from HK$52 million in 2005 to HK$44 million in 2006, owing mainly to a decrease in rail freight traffic (breakbulk and livestock) and the phasing out of the freight forwarding business.

Another factor affecting the freight business was the improving logistics industry and infrastructure in the Mainland, which intensified competition between the railway and other modes of transport. In order to strengthen its competitive position, the Corporation worked closely 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 were also underway during the year.

Freight Links


KCR

NETWORK EXPANSION



NETWORK EXPANSION

For the past 10 years, KCRC has been building world-class railways and meeting the transport needs of Hong Kong people. 2007 will see the completion of another important project.

Lok Ma Chau Spur Line
WORKS COMPLETED

Trial runs for
Lok Ma Chau Spur Line
99.9% ON TIME

150 METRES
of tunnels bored on
Kowloon Southern Link

OVER 50%
bulk excavation at West Kowloon Station site completed

Northern Link and
Express Rail Link
STUDIES ON TRACK
for completion by mid-2007

New Extensions

The year 2006 marked the 10th anniversary of the assumption of a new role for KCRC as a planner and builder of railways and the start of the West Rail project. It was also a year of significant achievement for the Corporation's current capital projects. The Lok Ma Chau Spur Line was substantially completed, the Kowloon Southern Link was in full swing, and planning was underway for future rail links that will connect Hong Kong directly to the Mainland's national express rail network.

1996–2006: A DECADE OF ACHIEVEMENT

When KCRC embarked on the West Rail project in 1996, the Corporation at that time functioned primarily as an operator of railways. Today, having completed West Rail, the Light Rail Extension, the Tsim Sha Tsui Extension and Ma On Shan Rail, KCRC is also a successful planner and builder of railways. That all 125 major contracts of these projects were completed on time and within budget is an achievement of which the Corporation can be justifiably proud.

These projects have given KCRC a unique capability in planning, designing and building railway projects to the highest possible standards. During the year the Corporation applied this expertise to three projects, currently in various stages of development. All three will add substantially to KCRC's network and will enable the Corporation to provide an even

The Lok Ma Chau Spur Line is on track for commissioning in 2007 more convenient, fully integrated transport service for the people of Hong Kong.

LOK MA CHAU SPUR LINE READY FOR COMMISSIONING

When the 7.4-kilometre Lok Ma Chau Spur Line opens for service in 2007, it will provide a second rail boundary crossing as an alternative for passengers travelling between Hong Kong and the Mainland.

We made substantial progress on this project during the year, having already completed the four-level cross-boundary terminal housing railway, customs and immigration facilities in April 2005.

By the middle of 2006 we had laid the tracks and energised the overhead lines. We had also installed the railway systems — the signalling system, control and communications systems, the ventilation system inside the tunnels, the Automatic Revenue Collection (ARC) equipment and the lifts and escalators at the terminus.

System Acceptance Tests commenced in May to ensure all equipment and systems met performance standards. This was followed by System Integration Tests in July to verify that the various interfacing systems were compatible.

Trial operations for the Spur Line commenced in August. During the trials, the trains ran in accordance with the timetable all the way from East Tsim Sha Tsui Station to Lok Ma Chau Station. The trial runs were successfully completed in September, with a punctuality rate of over 99.9%.

Also completed was the Public Transport Interchange adjacent to the terminus in the closed area of Lok Ma Chau. A trial bus run was conducted in late September and the Interchange will eventually be handed over to the Government's Transport Department.

THE KOWLOON SOUTHERN LINK IN FULL SWING

This project is strategically important for KCRC as it will integrate East Rail and West Rail, creating a unified rail network.

Civil construction works for the Kowloon Southern Link were well underway during 2006. The completion of this 3.8-kilometre railway in 2009 will extend West Rail from Nam Cheong Station to East Rail's East Tsim Sha Tsui Station via a new intermediate station at West Kowloon. It will also reduce the travel time between Tin Shui Wai and Tsim Sha Tsui to about half an hour, and eliminate the need to change trains.

One of the greatest challenges in constructing the Kowloon Southern Link has been working in a congested urban area without disturbing road traffic and local residents. For this reason, rather than adopt the conventional cut-and-cover method which would require major road closures, we decided to use the tunnel boring method along most of the route from East Tsim Sha Tsui to West Kowloon. Although tunnel boring is less disruptive, it means having to face the challenge of constructing two tunnels with a sharp curve and track radius of up to 225 metres.

By the end of the year, the tunnel boring machine (TBM) — named Xiaolongnu (Little Dragon Girl) — had reached over 150 metres from the launching shaft into the area beneath Canton Road.

Pipe piling works for the construction of the TBM retrieval shaft and the small section of cut-and-cover tunnels in Salisbury Road were completed in October. The retrieval shaft is targeted for completion in April 2007, ready for the arrival of the TBM in May 2007.

At the West Kowloon Station site, bulk excavation was over 50% complete by the end of the year.

Piling works for the conventional cut-and-cover tunnels on the northern section from West Kowloon Station to Nam Cheong Station were in full swing. By the end of the year, we had finished the advance works for tunnel excavation along Lin Cheung Road south of Cherry Street and continued north of Cherry Street. Excavation at Nam Cheong Park was completed and tunnel construction commenced in December.

In addition to minimising disturbances, we have also had to make allowance for the enabling works of the future Express Rail Link, which will have tunnels running under the Kowloon Southern Link.

Despite these challenges, the project is within budget and on schedule.

WHAT'S IN A NAME?
Xiaolongnu (Little Dragon Girl) is the 80-metre-long tunnel boring machine (TBM) adopted for the tunnels of the Kowloon Southern Link under Canton Road and Salisbury Road. It was officially launched at a vertical shaft within the site of West Kowloon Station in Canton Road in August. Named after a legendary character created by the highly acclaimed writer Mr Louis Cha, the TBM was designed in Germany, with parts manufactured in Germany and China. This state-of-the-art TBM weighs about 800 tonnes and is over 8 metres in diameter, larger than the fuselage of a Boeing 747 aircraft and twice its weight.

This tunnel boring machine was designed specifically for the Kowloon Southern Link

Future Projects

THE NORTHERN LINK/ EXPRESS RAIL LINK PROJECT

In February 2006 the Government invited 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.

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

The 30-kilometre Hong Kong section of ERL will start at a new terminus at West Kowloon. Various alignment options are being considered to link this terminus with a cross-boundary tunnel that will connect to the Mainland section of the ERL at the boundary at Huanggang. When completed, the ERL will become part of the national express rail network linking the Mainland rail hubs at Longhua in Shenzhen and Shibi in Guangzhou.

Consultants were engaged in October and December to carry out engineering, operational and business studies. These studies will be completed by mid-2007.

As the project will form part of China's express railway network, we are maintaining close liaison with our counterparts and the Ministry of Railways in the Mainland.

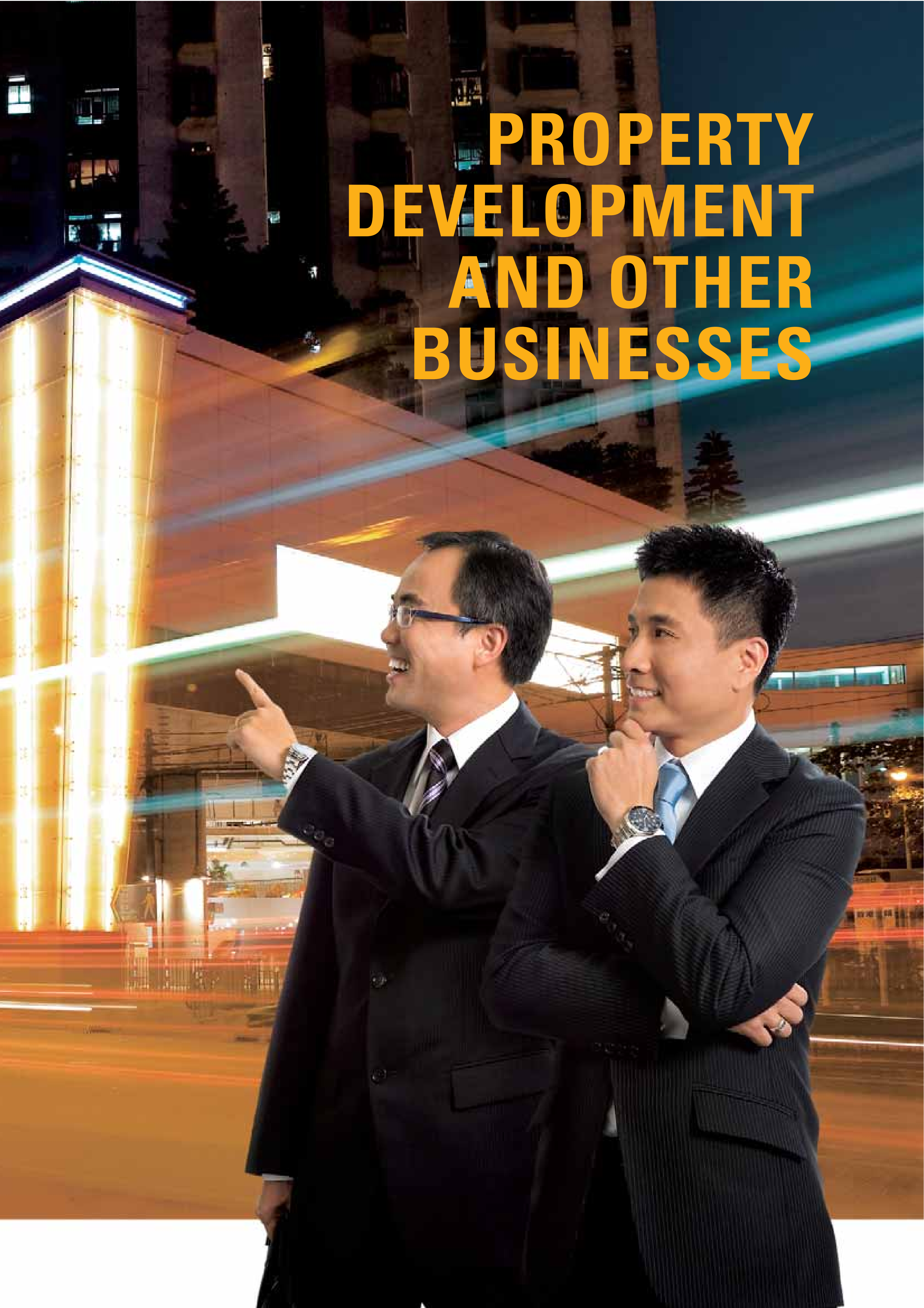
AWAITING DECISION ON SHATIN TO CENTRAL LINK

In 2002 the Corporation won the bid to plan, build and operate the Shatin to Central Link and, in 2004, submitted the Draft Final Proposal to the Government. The Draft 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. Adjustments were subsequently made to incorporate developments planned for South East Kowloon and Wanchai.

The decision of the Government on the construction of the Shatin to Central Link, to which the Government remains committed in principle, is awaited.


Ocean Walk

PROPERTY DEVELOPMENT AND OTHER BUSINESSES



Tai Wai Maintenance Centre and Tuen Mun Station
TENDERS AWARDED

6,300 UNITS
to be built in these developments

FOUNDATION WORKS COMPLETED
for Wu Kai Sha Station project

13.6% increase in recurrent revenue

Renovation of the
10,000 SQUARE METRE
Ocean Walk shopping centre

OVER 80%
of shop space at Lok Ma Chau Station pre-leased

PROPERTY DEVELOPMENT AND OTHER BUSINESSES

The Corporation works with established property developers to build high quality residential units in close proximity to KCR stations to secure a permanent and increasing ridership for the Corporation's railways and give the residents convenient access to the railway network.

Property Development

The Hong Kong economy continued to improve during the year, and the Corporation entered a new phase that will soon see one completed project following the other. This will not only provide KCRC with a steady, recurrent cash flow but also generate increased patronage on our railways.

Fuelled by economic optimism, the property market was buoyant in 2006 both in terms of sales price

PROPERTY DEVELOPMENT

	Residential floor area (sq m)	Commercial floor area (sq m)
Developed properties		
Pierhead Garden, Tuen Mun	91,400	9,832
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**	**345,140**
Property under construction		
Ho Tung Lau (Site A)	120,900	2,000
Tai Wai Maintenance Centre	313,955	–
Tuen Mun Station	119,512	25,000
Wu Kai Sha	168,650	3,000
Sub-total	**723,017**	**30,000**
Total	**1,484,353**	**375,140**

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

The joint venture development project at Ho Tung Lau (Site A) well underway during the year and rents. There were, however, signs of consolidation in the second half of the year following successive rises in interest rates. Buyers became cautious after substantial price escalations in the first six months of the year, which resulted in a substantial drop in transaction volume. This did not deter property developers from competing for the Corporation's joint venture property development projects that were tendered during the year.

PROPERTY DEVELOPMENT PROGRAMME FORGED AHEAD IN 2006

In 2006 the Corporation implemented its property development programme for sites along West Rail and Ma On Shan Rail in line with the co-ordinated programme agreed with the Government. Three projects were involved, and after inviting expressions of interest we successfully awarded the tenders for two of them — the Tai Wai Maintenance Centre and West Rail Tuen Mun Station developments.

Eleven tenders from four developers were received for the 7.1-hectare site above the Corporation's Tai Wai Maintenance Centre adjacent Tai Wai Station. The tender for the joint venture project was awarded in April to East City Investments Limited, a wholly-owned subsidiary of Cheung Kong (Holdings) Limited.

With 12 residential blocks providing about 4,300 residential flats, this is the largest development project ever undertaken by KCRC. It will be built in three phases, with a scheduled completion date for the last phase in 2010.

This was followed in August by the tender for a joint venture project at West Rail Tuen Mun Station. Acting as the agent of Tuen Mun Property Development Limited, we awarded the tender to Wetland Park Management Service Limited, a wholly-owned subsidiary of Sun Hung Kai Properties Limited. This project occupies an area of about 2.7 hectares and will have an approximate gross floor area of 145,000 square metres, comprising 120,000 square metres for residential use and 25,000 square metres for retail purposes.

Both projects will create nearly 6,300 new residential units. This means 6,300 families eventually living above our stations, which will consequently generate a welcome increase in ridership on our railways.

In October the Corporation received 13 expressions of interest for the joint venture property development at West Rail Tsuen Wan West Station TW7 site. Seven residential towers housing 1,776 flats will be built above a car park podium, together with a school of about 10,000 square metres. This project is planned to be tendered in the first quarter of 2007.

WEST RAIL PRIORITY PROPERTY SITES

Nam Cheong	(4.62 hectares)
Yuen Long	(3.46 hectares)
Tuen Mun	(2.66 hectares)
Tsuen Wan West	(9.38 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, with 92% of the gross floor area used to create 10,795 residential flats between 2008 and 2014.*

EXISTING PROJECTS CONTINUED ON SCHEDULE

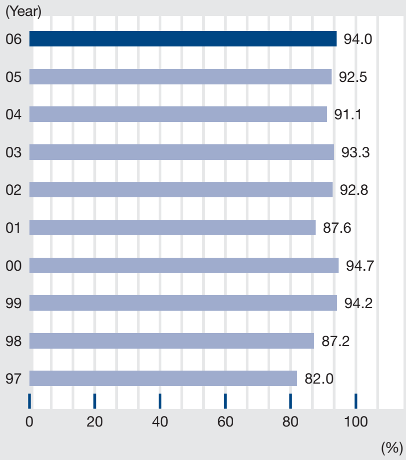
The Ho Tung Lau (Site A) joint venture project remained on schedule in 2006. The foundation works were completed, and pre-sales for the residential units are scheduled to begin in the third quarter of 2007. The Corporation's partner in the project is Full Fair Limited, a subsidiary of Sino Land Company Limited.

This 2.67-hectare project is a residential/commercial development, providing 122,900 square metres of gross floor area. Ten 37- to 40-storey residential towers will be built on a two-level podium, providing approximately 1,375 residential units. The Corporation will manage the development upon its completion.

The Wu Kai Sha Station joint venture project between the Corporation and its joint venture partner, Shine Harvest International Limited, a wholly-owned subsidiary of Sino Land Company Limited, also made excellent progress during the year. By year-end, the foundation works and detailed

PROPERTY OCCUPANCY RATE

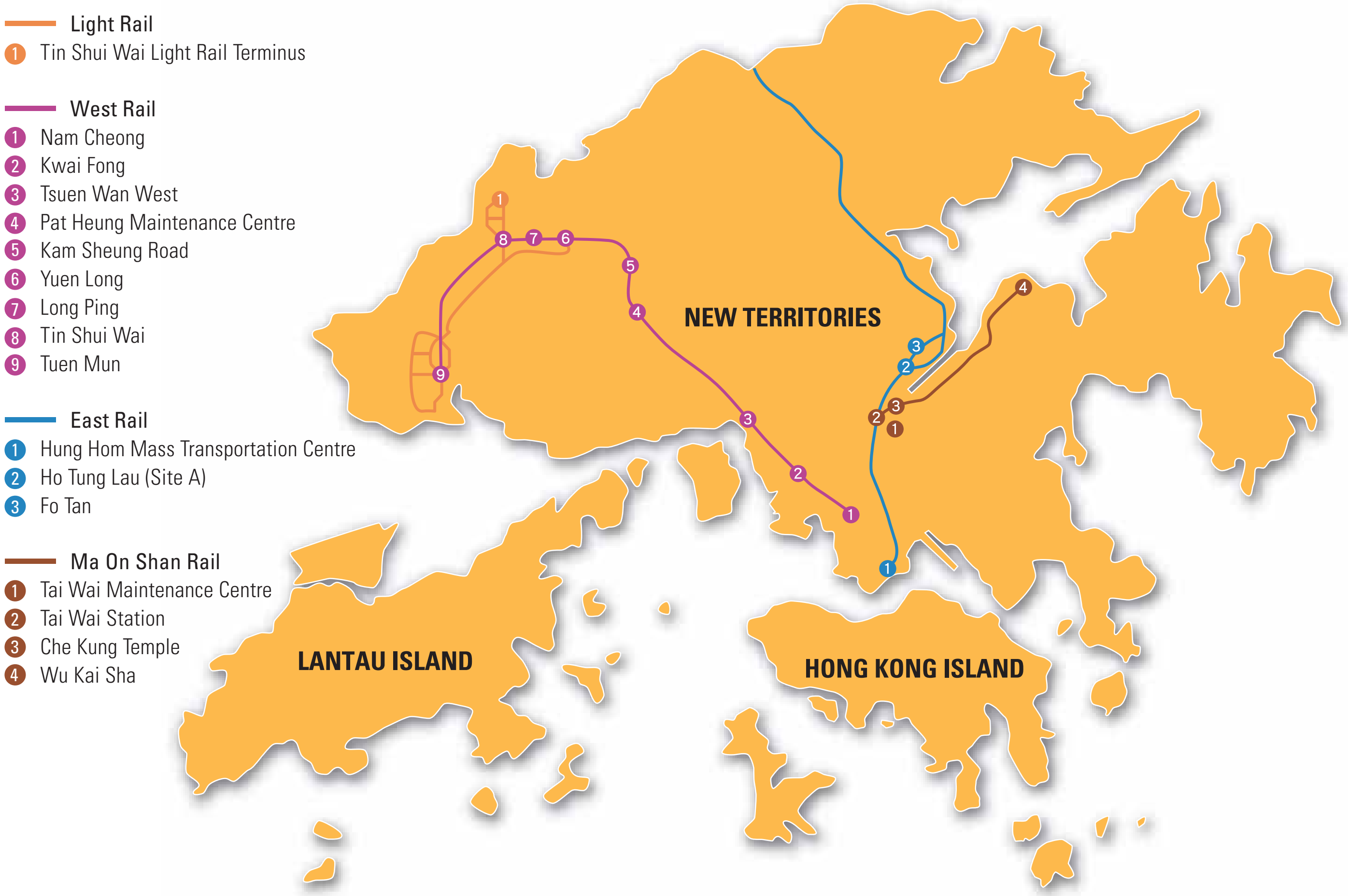
Station Commercial Premises, Commercial Offices and Shopping Arcades



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	9,832	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	**91,028**	**3,457**	**9,854**

Property Development Sites



PROPERTY SERVICES

Leasing of office buildings	(sq m)
Citylink Plaza	21,909
KCRC Hung Hom Building	5,576
Total	**27,485**

Leasing of shopping centres	(sq m)
Citylink Plaza	3,045
Ocean Walk (formerly Pierhead Plaza)	9,832
Sun Tuen Mun Shopping Centre	14,000
Hanford Plaza	3,200
Plaza Ascot	10,000
Total	**40,077**

Leasing of residential units 272 units

KCRC's shopping centres were made more competitive by extensive renovations and other incentive programmes

design of the building structure had been completed. The major building works contract was awarded and will commence in early 2007.

WE ENVISION A GREENER, BETTER HONG KONG

In 2006 the Linear City Research Project came to its conclusion after three years of examining the role of railway in the life of the city.

Guided by the Government's call to increase rail's share of public transport to 60% by 2030, this project aimed at developing innovative and sustainable strategies for a more liveable Hong Kong. The project was a cooperative effort between KCRC staff and a diverse team of academic researchers.

Many factors were taken into account, including socioeconomic issues, education, health and the environment. Findings from the research suggest that future policies should be guided by a combination of balanced key success indicators, comprising ridership growth, minimisation of physical congestion, community integration and urban design considerations.

For the final module, we are now considering some live projects for implementation of the theories that have come out of the research. It will take more than KCRC's own efforts, however, to make these theories succeed.

Other Businesses

SATISFACTORY RESULTS IN OUR OTHER BUSINESSES

In the improved economic environment of 2006, recurrent revenue recorded an overall increase of 13.6%. This came mainly from the good performance of our Duty Free business, exhibition business, Newsline Express and the substantial increase in rents at Ocean Walk in Tuen Mun after its extensive renovation. The occupancy rate of both station shops and shopping centres was maintained at an average of 94% at the end of 2006.

With the rise in the number of Mainland visitors to Hong Kong and the implementation of a series of intensive promotional campaigns, the Duty Free business at East Rail and onboard through trains achieved a 10.8% increase in revenue over 2005. The improved market sentiment also stimulated bookings from exhibitors, such as telecom operators and banking institutions, for promotion of their services. Exhibition revenue was thereby increased by 14.9% during the year.

The launch of Newsline Express, Hong Kong's first on-train quasi real-time audio-visual system, received a positive response from our passengers. During the year this service achieved a 47.2% increase against budget, owing mainly to the introduction of special highlights of the 2006 FIFA World Cup by our partner, Hong Kong Cable News Express Limited.

STATION COMMERCIAL ACTIVITIES

- Duty Free business
- Restaurants
- 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

TELECOMMUNICATIONS SERVICES

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

ADVERTISING AND PROMOTIONS

- Poster advertising
- Large outdoor advertising displays
- Feature advertising
- Promotional free-standing displays
- Distribution of free newspapers
- Commercial exhibitions
- Promotional activities
- Multi-media advertising system – Newsline Express

In the second quarter of 2006, we completed the renovation work for Ocean Walk in Tuen Mun with a total area of around 10,000 square metres. After the completion of the works, we were able to improve the trade mix and quality of tenants substantially. A rental increase of around 48% was achieved after the renovation.

In early 2006 we disposed of all premises at Manlai Court, including five retail shops and three carparking spaces. This was part of a continuing evaluation of our existing investment property portfolio, and we will continue to dispose of those properties with limited revenue growth potential. At the same time, we will consider acquiring quality shopping centres in new property developments along railway lines for long-term investment, with particular emphasis on improving our recurrent non-fare revenue.

We have also been seeking opportunities to expand our retail areas in stations. For example, in 2006 we added around 240 square metres of shop space at Sheung Shui and Lo Wu stations. Renovation works in these two stations are still in progress, and an additional 300 square metres of station space will be created in 2007. Similarly, in mid-2006, KCRC commenced renovation works at Tai Po Market Station to provide an additional 300 square metres by mid-2007. With the completion of these works, a rental increment of 48% for these stations will be achieved. We also plan to increase the retail area at Mongkok Station. Renovations will take place in 2007, which will provide an additional area of around 500 square metres.

Over half of the tenancies in West Rail stations expired at the end of 2006, three years after the opening of the railway line. Some of the tenants could not maintain their operations and, as a result, the occupancy rate of West Rail shops dropped to 80% at the end of 2006. To improve the situation, we have adopted a flexible leasing strategy with a view to filling as many shops as possible.

For the new Lok Ma Chau Spur Line, we have provided 69 new shops (not including the new duty free operation) for the new terminus when it opens in 2007. Over 80% of the shops were pre-leased by the end of 2006, with a wide mix of tenants to serve domestic and cross-boundary passengers.

Competition among shopping centres was keen at the regional level. To maintain the sales momentum of our shopping centres, the Corporation carried out a series of promotional activities and events during festive periods such as Easter, Halloween, Christmas and New Year. To build on the success of these activities, we sought feedback, suggestions and support from shop tenants to improve our promotional plans for 2007.

In the year ahead, we will further expand the property management services we offer within the Corporation's investment properties and station shops in order to enhance their value.


process improvement
To equip you with the tools and
techniques to bring about process
improvement projects
To enhance your ability in

HUMAN RESOURCE AND QUALITY MANAGEMENT

6,049
permanent and contract staff

3,000 STAFF
attended 42 "Embracing Change" seminars

2,000 FRONTLINE STAFF
trained in 80 customer service courses

2,382 STAFF
took part in e-Learning programmes

7 DAYS TRAINING
for each employee on average

HUMAN RESOURCE AND QUALITY MANAGEMENT

Following the Government's announcement in April of the possible rail merger, the Human Resource Division played a key role in preparing for change and creating enthusiasm for the Corporation's future direction.

Human Resource

In 2006 the Human Resource Division focused on engaging staff at all levels in a process of continuous self-improvement, confidence building and commitment. In so doing, the Division helped to fulfil the Corporation's responsibilities as a good employer and responsible corporate citizen.

With 6,049 permanent and contract staff, KCRC is among Hong Kong's largest employers. The merger announcement, the construction and completion of new projects, and the need to strengthen transparency and accountability have created an environment of rapid change for both staff and the Corporation as a whole.

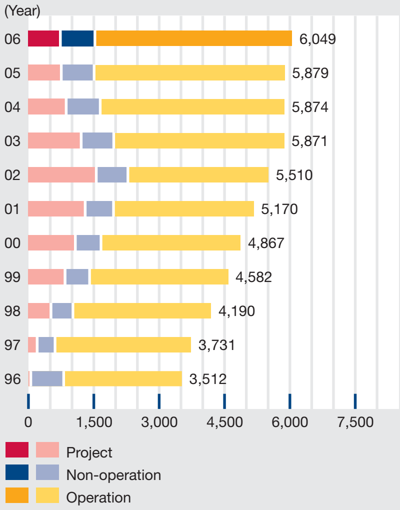
STAFF TRAINING AND DEVELOPMENT

During the year we made a deliberate effort to equip staff for change and prepare them for future challenges. Numerous training and development programmes were held to enhance business skills and the overall competencies of staff. A total of 351 training classes were organised in 2006, compared with 269 classes in 2005, representing an increase of 30%. Each employee received an average of seven days' training in 2006.

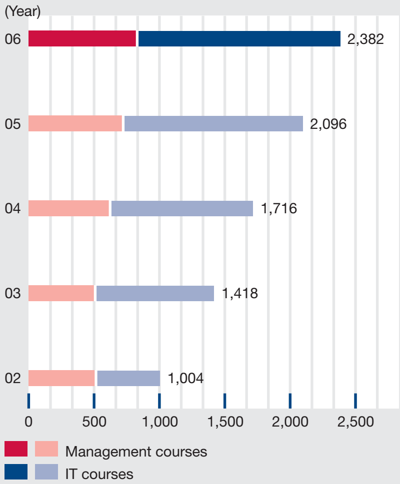
At the core of these programmes was "Embracing Change for Future Success". This series of programmes covered a wide variety of topics, such as change management, career planning, presentation skills, business Putonghua, innovation, influencing skills, image building and business networking, understanding the railway business and personal

Staff are encouraged to upgrade their knowledge and skills through self-learning

STAFF NUMBERS



PARTICIPATION IN E-LEARNING PROGRAMMES



KCRC won a grand award for its GEM quality circle at the Quality Improvement and Experience Sharing Convention

A series of seminars with well-known guest speakers held during the year

effectiveness. During the year, 42 classes were organised with over 3,000 staff participating.

In partnership with the Operations Training Team, a large-scale customer service training programme for all frontline staff was held from January to March in support of the "Go the Extra Mile" (GEM) campaign. Over 80 classes were organised with around 2,000 frontline staff receiving training in the provision of excellent customer service.

For executive managers with high potential, we organised a 12-day mini-EMBA programme delivered by a world-class executive education provider, the Richard Ivey School of Business of the University of Western Ontario. A negotiation skills workshop was also conducted by the Harvard Business School faculty.

Outside the classroom, staff were highly encouraged to upgrade their knowledge and skills through self-learning. Over 50 e-Learning courses in language, management and IT subjects were offered to staff so that they could study at their own pace and time, at home or in the office. Since the launch of e-Learning courses in 2002, enrolment has increased from 1,004 to over 2,382, an increase of more than 130%. In 2006 e-Learners received an average of 8.61 e-training hours.

More than 3,500 items, including books, videos and self-paced learning and multimedia training packages, were also made available to staff at the Learning Resource Centre. The loan rate has increased almost three-fold from 2,420 items in 2002 to 9,170 in 2006.

Quality Management

The Corporation launched the GEM campaign in July 2005 as part of the ongoing effort to promote service excellence. In 2006 we arranged for all frontline operations staff to attend customer care training courses, which were aimed at encouraging them to go the extra mile in serving our customers and exceed their expectations.

A GEM Commendation Card scheme was also launched to acknowledge examples of outstanding customer service. At the heart of this scheme are the GEM Change Champions, an internal group of over 100 specially selected and trained staff formed to bring about cultural change in the Corporation. Whenever the Change Champions spotted an example of excellent service by KCRC staff members, they would immediately present those staff with a Commendation Card. As a result of this scheme and the training received by staff, the satisfaction levels of passengers went up steadily, as indicated in the Corporation's regular surveys held during the year.

The Corporation's staff suggestion scheme, Ideas-hub, received over 100 suggestions in its second year of operation. Staff submitted a wide variety of suggestions, ranging from ideas on improving the Corporation's environmental initiatives and customer satisfaction levels to new ways of generating revenue and increasing safety.

As a founding member of the Hong Kong Quality Improvement and Experience Sharing Convention, KCRC continued to support this effort. In November, the Corporation once again shared its successes with other organisations at the Convention's annual event and won one of the grand awards for its quality circle on GEM.

THE DRIVE TOWARDS SUSTAINABILITY


增廣見聞
鐵路遊
KCR

ISO 14001:2004
for Capital Projects Division

Gold **WASTEWI$E**
logo awarded for reducing waste

Over **200 SPECIES**
of birds at Lok Ma Chau wetlands

4,000 HOURS
of volunteer work

Fourth year as a
CARING ORGANISATION

FREE VACCINATIONS
for all staff

Over **1,000 STAFF**
attend wellness programmes

Only **6.57**
accidents per 1,000 employees

THE DRIVE TOWARDS SUSTAINABILITY

KCRC is firmly committed to fulfilling its social, economic and environmental responsibilities and promoting progress for the benefit of passengers, staff, the community at large and the environment.

The Drive Towards Sustainability

During the year the Corporation continued to implement environmentally-responsible measures in its major infrastructure projects and began to see some remarkable returns from this investment. In anticipation of a possible rail merger, KCRC provided a series of change management workshops, seminars and activities designed to prepare staff for the smooth integration of the two systems. At the same time, the Corporation enhanced its efforts to reach out to the community with programmes that helped those in need and contributed to the health, safety and well-being of its staff.

The Environment

COMMITTED TO THE ENVIRONMENT

By the very nature of the service it provides, KCRC operates a clean mode of mass transport that has relatively little impact on the environment. Nevertheless, the Corporation also believes it has a responsibility to take the lead in environmentally-sustainable practices and has set an example for other railways in Asia to follow.

KCRC was the first public transport operator in Asia to obtain corporation-wide ISO 9001 certification and an ISO 14001 environmental management system certificate in 1997. At the end of 2006 the Capital Projects Division gained ISO 14001:2004 certification for the management system used by the Corporation to monitor and control the environmental impacts of its new projects.

The Corporation is also a founding Council Member of the Business Environment Council and one of the participating organisations in the Clean Air Charter of the Hong Kong Business Coalition on the Environment.

Internally, KCRC has shown its commitment to improving its environmental performance by establishing a Corporate Environmental Steering Committee. Its responsibilities are to propose corporate environmental policy, objectives and targets, and to formulate appropriate environmental programmes to achieve them. In addition, it has been tasked to monitor the Corporation's environmental performance and advise on improvement measures where necessary.

KCRC is also one of the participating organisations in the Environmental Protection Department's "Energy Conservation Charter – suitable room temperature". The Charter was a part of the Department's Action Blue Sky campaign, which encourages organisations to reduce the use of air-conditioning and save energy.

To engage staff in various environmental initiatives, the Corporate Environmental Steering Committee launched KCRC's inaugural Environmental Week in June, which involved a full range of activities, seminars and site visits to areas of interest, such as the environmental headquarters of the Electrical & Mechanical Services Department and the Hongkong Electric pilot wind turbine project on Lamma Island.

At the Environmental Week opening ceremony, the Corporation was presented with the Hong Kong Awards for Industries: Environmental Performance Award in recognition of its environmental work, energy savings and waste reduction achievements over the past several years. The Corporation won its first Environmental Performance Award in 1999.

Earlier in the year, the Corporation earned the Environmental Protection Department's Gold Wastewi$e logo after achieving waste reduction targets set the previous year under this Government scheme.

To ensure cleaner air for future generations, KCRC signed a contract to purchase 20 new environmentally-friendly buses at a cost of HK$55 million. Fitted with the Euro IV engine, these buses will be the first of their kind in Hong Kong and will meet the strictest environmental and safety standards.

As an environmentally-responsible organisation, we have put in place measures to use power more efficiently. At West Rail we adjusted station interior temperatures in both public areas and back-of-house, and redesigned station lighting controls so that lights could be controlled more efficiently to save energy.

WE ALSO ENHANCE THE ENVIRONMENT

The Corporation not only takes into consideration measures for protecting the environment but also ways to enhance the environment in all aspects of new railway construction.

An example of this is the creation of wetlands to compensate for the loss of wildlife habitat. For the Lok Ma Chau Spur Line project, KCRC constructed a 37-hectare ecologically enhanced wetland habitat of fishponds, marsh area and reed beds for breeding and roosting birds. The Corporation hired ecological specialists to determine the effectiveness of the enhancement work and formulate strategies to attract different bird species. These KCRC managed wetlands have exceeded the most optimistic expectations, attracting over 200 species of birds and even some endangered species never before seen in Hong Kong.

The West Rail recreated wetlands have been equally successful and continued to be well maintained, as evidenced by the discovery of rare and uncommon dragonflies, birds and butterflies during a summer survey.

Social Awareness

SOCIAL AWARENESS BRINGS US CLOSER TO THE PUBLIC

During the year the Corporation held a series of regular surveys to gauge customer satisfaction. These included KCRC's annual surveys on market share, cross-boundary travel and back-to-school service; ad hoc surveys on Light Rail's route rationalisation and the acceptance of automatic platform gates; and a customer satisfaction survey, which is conducted every four years.

As a public corporation, KCRC recognises the need to be transparent and accountable. The Corporation therefore maintains regular communication with the public through a variety of channels. One of these is the Public Consultation Group, with members drawn from the Traffic and Transport Committees of the District Councils and passenger groups. Through this channel, KCRC is able to keep the public informed of its plans as well as obtain feedback.

Other channels included meetings with Passenger Liaison Groups, the KCRC Café and Community Liaison Groups. To answer public concerns about the impact of the Corporation's new projects, Community Liaison Offices were operated throughout the year.

To increase accountability and transparency, the Corporation continued its practice of reporting any incident that might cause delays in railway service by eight minutes or more. Previously, this was only done for incidents lasting 20 minutes or longer.

Reaching out to the Community

OUR STAFF HELP THOSE IN NEED

KCRC encourages its staff to reach out to the community and help underprivileged members of society.

During the year the Corporate Volunteer Team grew to 300 members, who devoted 4,000 hours of their free time to help the elderly, young people and the disabled. Members also took part in environmental protection programmes in the community.

Other community activities carried out by the Corporation included a total of 32 school talks and visits to community groups, the KCRC Art Corner at East Tsim Sha Tsui Station to promote public appreciation of art works by local artists, and an Educational Tour and Life Review Story Programme.

Under the Educational Tour Programme, members of the Corporate Volunteer Team took groups of children from low-income homes on free visits to museums in urban areas. In 2006 the programme was extended from West Rail to cover areas along East Rail. About 30 tours were organised in the year, benefiting more than 700 children. This programme received a Merit Award in the Corporate Volunteer Service Project Competition 2005 organised by the Social Welfare Department.

The Life Review Story Programme is provided in partnership with the Po Leung Kuk charitable organisation. Under this programme, members of the Corporate Volunteer Team paid regular visits to homes of senior citizens and helped them produce visual memoirs of their lives. The intention of the programme is to promote self-esteem among the elderly. In the first round of visits, 46 volunteers helped 73 elderly people compile pictorial memoirs. The team then held a roving exhibition in June at Hung Hom and Mong Kok stations of a book featuring some of the memoirs. A new round of activities was held in September for compiling the memoirs of an additional 16 senior citizens.

Works by local artists on display at the KCRC Art Corner at East Tsim Sha Tsui Station to promote public appreciation of art

Another programme, the KCR Train Library, encourages passengers to read while taking public transport. Located at Sha Tin Station, the library has received over 10,000 books donated by Corporation staff and the public since its launch in mid-2005.

In 2006 the Corporation continued its support of charitable causes, participating in The Community Chest's fundraising activities, as well as other charity events and environmental awareness programmes. KCRC staff donated used spectacles, computers, clothing and food — including surplus Chinese New Year treats, mooncakes and canned food — to charitable organisations.

KCRC also took part in the Caring Company scheme once again, and received the "5 Year Award Logo" from The Hong Kong Council of Social Service in early 2007.

Caring for Staff

STRIVES TO BE A CARING EMPLOYER

As a caring employer, we made a strong effort in 2006 to support staff in their work and personal lives. To foster a more harmonious, transparent and productive working environment, the Corporation further improved existing communication channels by allocating additional resources to its Staff Relations Section for listening and responding to staff concerns. The proposed merger was a particular issue where good communication was critical, given the potential for uncertainty among staff. Staff were consulted and briefed on the progress of the merger as information became available.

Since the announcement of the merger in April, we have held nearly 40 mass briefings, about 60 meetings with unions and staff consultative committees, and more than 300 local briefings. In addition to the briefings, the Corporation invited comments and views of staff through a dedicated hotline, mailbox, email, intranet and newsletter. Feedback from these channels indicated that employees welcomed the efforts of management to communicate clearly and openly with them.

Owing to the increased risk of a flu epidemic, the Corporation implemented a response plan to reduce the risk to its staff and to ensure business continuity in the event of an outbreak. Free influenza vaccinations were also offered to protect employees against infection. In October and November, over 2,500 staff members received

Members of the Corporate Volunteer Team prove they have a "heart" on-site vaccinations at major work locations. Vaccinations at appointed clinics were arranged for those who missed the on-site vaccinations.

KCRC established a number of other caring programmes to improve the health and well-being of staff and to enhance their morale, productivity and commitment to the organisation. Wellness programmes, covering topics such as work-life balance, nutrition, weight management, and Neuro Linguistic Programming (NLP) activities were offered to enhance holistic fitness. The response to these programmes, which attracted over 1,000 staff, was overwhelming.

Also offered were personal counselling and coaching sessions for individual employees, and stretching exercises on the intranet for office staff.

Health and Safety

HEALTH AND SAFETY — THE HIGHEST PRIORITY

Both as a provider of essential transport services and as a caring, responsible employer, the Corporation places the highest importance on the health and safety of its staff, passengers and the construction workers in its employ.

As a result of the Corporation's continued efforts to reduce accidents in the workplace, the staff accident rate in 2006 was 6.57 per 1,000 employees, well below the Hong Kong average of 17.5 accidents per 1,000 employees recorded in 2005.

KCRC staff contribute to a corporate culture in which safety takes precedence

The Corporation's strong commitment to safety and the high standard of its safety management practices were reflected in the report by the American Public Transportation Association (APTA). This report followed its review in 2006 of the progress KCRC had made in implementing the recommendations given by APTA in its 2005 safety audit. APTA stated that "KCRC has the systems in place to make a strong safety programme and is diligent in the implementation of its plan. APTA applauds KCRC for its outstanding effort in safety and security — it is well earned!"

One of the large-scale safety events held in the year was Corporate Safety Month, hosted in cooperation with the MTR Corporation in September. About 500 staff from both corporations participated in a series of talks on safety and risk management during the month.

The Corporation also shared its best practices and experiences in health and safety with other utility companies through a Joint Utilities Safety & Occupational Health Policy Group. In November the Corporation hosted Safety Forum 2006 during which speakers from government departments and utility companies shared with 130 participants their views on safety issues.

Another important initiative was the continuation of the voluntary Occupational Injury Rehabilitation Programme, which was launched in 2005. This self-funded programme provides prompt, responsive and appropriate rehabilitation services to staff injured in the course of their work. In a recent user survey, respondents confirmed that the programme has been very effective in helping injured staff make an optimal recovery and re-assimilate into the workplace. The

CONSTRUCTION SAFETY

Number of reportable accidents per 1,000 workers

	2003	2004	2005	2006
Lok Ma Chau Spur Line	4.08	13.68	13.98	**6.19**
Kowloon Southern Link (works commenced in 2005)	–	–	2.72	**1.38**
Public Works Contracts[1]	20.30	19.80	17.40	**17.40**
HK Construction Industry[2]	68.10	60.30	59.90	**N.A.**

[1] *Source – Environment, Transport and Works Bureau*
[2] *Source – Labour Department*

PASSENGER SAFETY

Number of passengers and members of the public injured per million passenger journeys

Year	2003	2004	2005	2006
East Rail*	0.65	0.74	0.71	**0.74**
West Rail	2.33	0.79	0.55	**0.51**
Light Rail	0.25	0.14	0.17	**0.29**
Bus	0.10	0.21	0.18	**0.15**

* *including Tsim Sha Tsui Extension and Ma On Shan Rail*

programme, which is managed by a team of rehabilitation professionals, is free of charge to all staff.

To ensure emergency medical care is available for passengers, KCRC posted qualified staff at each station along East Rail, West Rail and Ma On Shan Rail. Since February 2005, the Corporation has been sending station staff on one of the world's leading first-aid courses — Pre-hospital Trauma Life Support (PHTLS) — so that they are capable of accurately assessing any injury to a passenger and providing appropriate medical care before the arrival of the ambulance. In 2006 a total of 154 staff members were trained and qualified as Pre-hospital Trauma Life Support Providers. Additional staff will continue taking the course, so that every station is 40% staffed by qualified candidates by the year 2008.

Since escalator and platform gap accidents account for 75% of all passenger injuries, the Corporation implemented various measures to enhance passenger safety, including the installation of bollards at all heavily-used escalators to prevent passengers with bulky luggage endangering other passengers and the addition of warning labels, posters and audible warning devices to remind passengers to hold the escalator handrail. In order to reduce platform gap incidents, the Corporation made plans to install an Intelligent Platform Extension System at selected East Rail stations with curved platforms. Lo Wu Station will be the first station equipped with this system, and if proved successful other stations will be fitted with the system as well.

To enhance passenger safety awareness, a series of promotional events was held in 2006. Key messages focused on discouraging trespassing onto railway tracks, encouraging the safe use of escalators and reminding passengers to be aware of platform gaps at stations. A safety campaign was also devised specifically for educating Light Rail road users on the traffic regulations at Light Rail crossings.

The Corporation is widely known for setting and achieving extremely high safety standards for its new railway projects, which far exceed established Hong Kong standards and practices. A recent initiative implemented by the Corporation was to provide 30 hours of mandatory training to frontline site staff on how to maintain a safe working environment and ensure that contractors achieve the highest possible safety standards on their sites.

Construction safety was maintained to a very high standard during the year, with no major construction incidents.

$19 BILLION
interest-bearing borrowings

89%
borrowings denominated or hedged into HK dollars

74%
fixed interest rate borrowings

Credit Ratings
UPGRADED
by Moody's and Standard & Poor's

$1.9 BILLION
investment funds

INVESTMENT AND FINANCING STRATEGIES

During the year KCRC's long-term foreign currency rating was upgraded by Moody's in line with the upgrading of the Hong Kong SAR Government's foreign currency rating. Also during the year, KCRC's long-term local currency corporate credit rating and long-term foreign currency corporate credit rating were upgraded by Standard & Poor's.

FINANCING

KCRC's sources of financing include bond issues, export credit facilities and bank borrowings. As at 31 December 2006, the Group had interest-bearing borrowings of HK$19,212 million, with an average maturity of 3.21 years. The average cost of borrowing was 7.74%.

CREDIT RATING

In May 2006 Moody's upgraded KCRC's long-term foreign currency issuer rating from A1 to Aa3, following the upgrade of the foreign currency country ceiling for the Hong Kong SAR from A1 to Aa1. In September 2006 Moody's also upgraded Hong Kong SAR's long-term foreign currency rating from A1 to Aa3.

In July 2006 Standard & Poor's upgraded KCRC's long-term local currency corporate credit rating and long-term foreign currency corporate credit rating from AA- to AA.

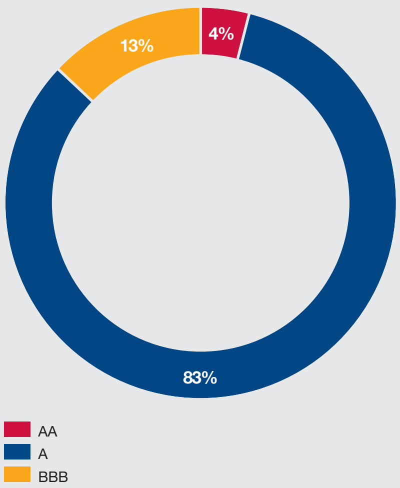
INVESTMENT

As at 31 December 2006, the Group's cash and cash equivalents amounted to HK$1.9 billion. All the funds were invested by the Corporate Treasury Department in a diversified portfolio of short-term bank deposits.

RISK MANAGEMENT

KCRC 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 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.

COMPOSITION OF INVESTMENTS BY CREDIT QUALITY



INVESTMENTS

	2006 (HK$ million)	2005 (HK$ million)
Cash and cash equivalents	**1,947**	3,394
Funds taken over from investment managers – fixed income portfolios	**–**	400
Deposits placed with custodian bank	**–**	49
Total	**1,947**	3,843

Moreover, we seek to limit our exposure to interest rate risk by maintaining fixed interest rate debts at between 30% and 75% of total debt obligations.

As at 31 December 2006, the proportion of borrowings denominated or hedged into Hong Kong dollars stood at 89% (2005: 87%).

As at 31 December 2006, the proportion of fixed interest rate borrowings stood at 74% (2005: 73%).

COMPLIANCE

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

To ensure compliance with the requirements of Section 404 of the Sarbanes-Oxley Act, KCRC appointed a consultant to provide assistance in developing the appropriate control documentation regarding KCRC's internal control system over financial reporting. The consultancy assignment was completed in July 2006.

CREDIT RATINGS

	2006
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 local currency issuer rating	**Aa3**
Long-term foreign currency issuer rating	**Aa3**
Senior unsecured local currency debt rating	**Aa3**
Senior unsecured foreign currency debt rating	**Aa3**

The credit ratings for KCRC 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

	2006 (HK$ million)		2005 (HK$ million)	
	Drawn	Undrawn	Drawn	Undrawn
Medium term note programme	**8,994**	**14,418**	8,973	14,377
Global notes	**7,804**	**–**	7,783	–
Retail notes	**1,000**	**–**	1,000	–
Export credit loan facilities	**1,407**	**10**	1,700	11
Syndicated loan facilities	**–**	**8,000**	–	8,000
Bank overdraft facilities	**–**	**25**	–	25
Letters of credit	**–**	**20**	–	20
Letters of credit for leveraged leases	**–**	**2,279**	–	2,273
Uncommitted short-term facilities	**–**	**2,200**	–	2,200
Total	**19,205**	**26,952**	19,456	26,906

$278 MILLION
net profit after tax

$4,746 MILLION
transport revenue

$876 MILLION
commercial revenue

$427 MILLION
profit on property development

$3,317 MILLION
capital expenditure

$363 MILLION
net cash outflow

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.

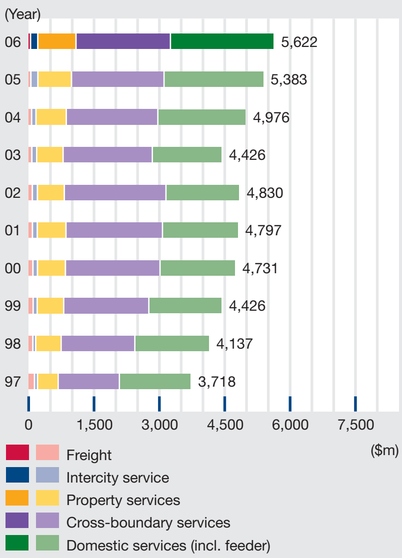
PROFIT AND LOSS

Transport revenue increased by 2.9% to HK$4,746 million during the year, compared with HK$4,612 million in 2005, mainly because of the growth of the cross-boundary market as well as the continuous build up in patronage on the Tsim Sha Tsui Extension, Ma On Shan Rail and West Rail resulting from the continuation of various measures to improve accessibility and the introduction of promotional offers.

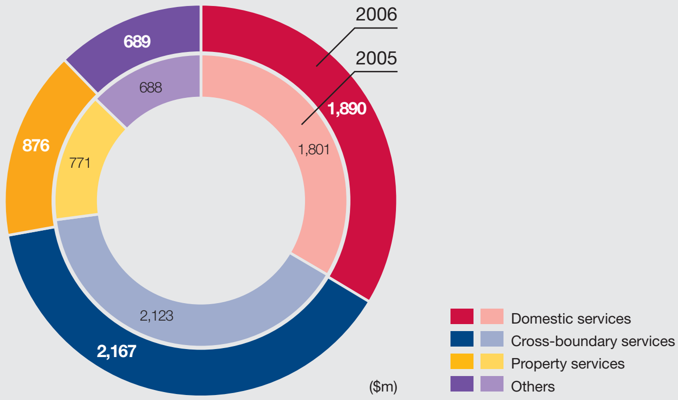
Commercial revenue for 2006 from the lease of shopping centres and office space, estate management, telecommunications, advertising, station kiosks and shops increased by 13.6% to HK$876 million from HK$771 million in 2005, mainly because of the improved performance of the duty free business, shopping centres, advertising, exhibitions and station trading.

Operating costs before depreciation and amortisation for 2006 increased marginally by 0.5% to HK$3,042 million from HK$3,027 million in 2005, despite the impact of general inflation. Staff costs increased by 1.4% to HK$1,543 million from HK$1,521 million in 2005; energy costs reduced by 2.2% to HK$484 million from HK$495 million in 2005; maintenance, spares and supplies costs grew by 9% to HK$522 million from HK$479 million in 2005; and other expenses decreased by 7.3% to HK$493 million from HK$532 million in 2005.

RECURRENT REVENUE



SHARE OF RECURRENT REVENUE



Operating profit before depreciation and amortisation increased by 9.5% to HK$2,580 million in 2006 from HK$2,356 million in 2005.

The operating margin before depreciation and amortisation and net interest and finance expenses/(income) increased from 43.8% in 2005 to 45.9% in 2006.

Depreciation and amortisation increased only by 1.3% from HK$2,258 million in 2005 to HK$2,288 million in 2006. Therefore, operating profit after depreciation and amortisation increased by 198% from HK$98 million in 2005 to HK$292 million in 2006.

Net interest and finance expenses increased by 6% to HK$316 million in 2006, from HK$298 million in 2005.

Profit from property development of HK$427 million was recognised in 2006, representing the surplus of initial payments and upfront payments received from the developers over the related enabling works construction costs after taking into consideration the outstanding risks and obligations of the enabling works.

A share of profit of an associate of HK$27 million was recognised in the year, compared with HK$15 million in 2005, representing an increase of 80%.

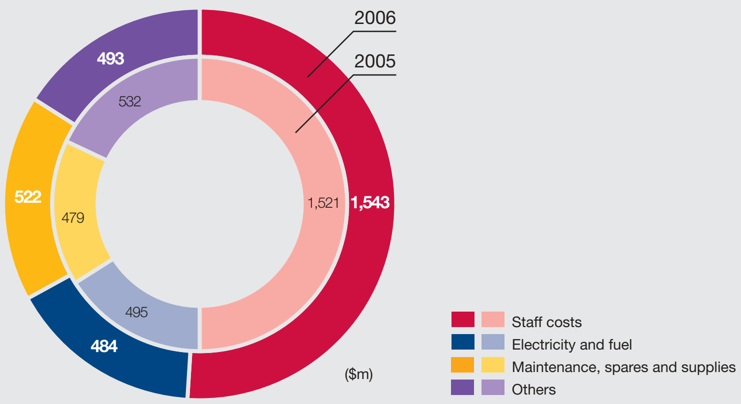
After taking into account the above, a profit before unrealised gains/losses and tax of HK$430 million was recorded in 2006, compared with a loss of HK$185 million in 2005.

The net unrealised accounting losses resulting from the changes in fair value of investment properties, financial instruments and the hedged portion of interest bearing borrowings were HK$99 million in 2006, compared with a profit of HK$571 million in 2005.

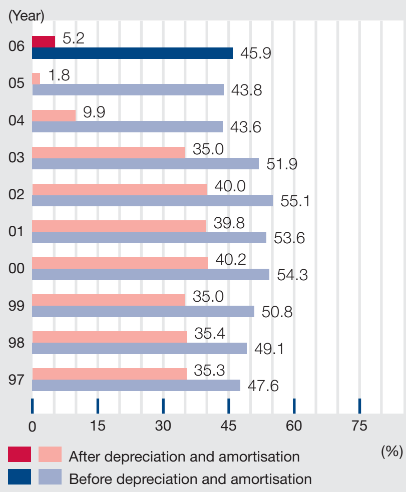
Income tax in the amount of HK$53 million was recognised in 2006, compared with HK$69 million in 2005.

As a result of the unrealised accounting losses, net profit after tax was HK$278 million in 2006, a drop of 12.3% from HK$317 million in the previous year.

OPERATING EXPENSES



OPERATING MARGIN



CAPITAL EXPENDITURE

Capital expenditure decreased by 13.5% from HK$3,835 million in 2005 to HK$3,317 million in 2006, mainly because of the completion of outstanding works of the Tsim Sha Tsui Extension and Ma On Shan Rail, partly offset by the progress of works for the Kowloon Southern Link. The capital expenditure of 2006 was mainly for the construction of the Kowloon Southern Link and the outstanding works of the Lok Ma Chau Spur Line, investment to prepare for the replacement of aged assets, and safety and environmental improvements.

CASH FLOW

The net cash inflow from operations increased by 10.6% to HK$2,664 million from HK$2,408 million in 2005. On the other hand, the net cash inflow from property development increased by 342.6% to HK$1,505 million from HK$340 million in 2005. After taking into account the increased capital expenditure for the Kowloon Southern Link and lower interest received, net cash inflow before financing increased to HK$1,421 million from HK$1,124 million in 2005. Net cash outflow from financing activities decreased from HK$1,876 million in 2005 to HK$1,784 million. As a result, there was a net cash outflow of HK$363 million for the year, compared with HK$752 million in 2005.

TRANSPORT

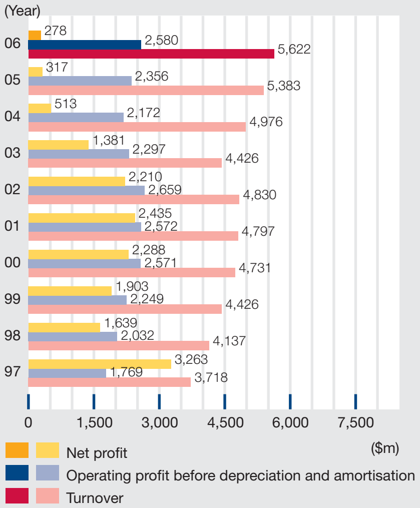
East Rail revenue increased 3% from HK$3,670 million in 2005 to HK$3,780 million in the year, mainly due to the growth of the cross-boundary market and the continuous build up of the Tsim Sha Tsui Extension and Ma On Shan Rail patronage.

West Rail and Light Rail revenue as a whole increased 3.6% from HK$890 million in 2005 to HK$922 million in the year, mainly because of the increase in West Rail patronage resulting from the continuation of various measures to improve accessibility and the introduction of promotional offers.

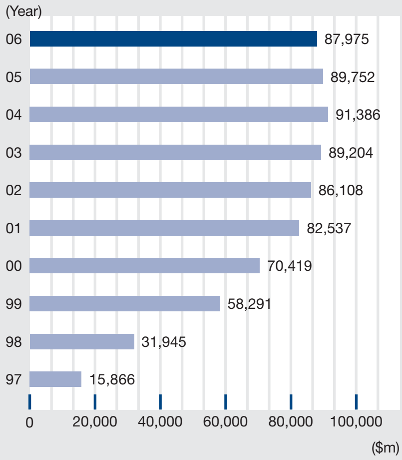
Freight revenue decreased by 15.4% to HK$44 million in 2006 from HK$52 million in 2005, mainly as a result of decreases in rail freight traffic and the cessation of the freight forwarding business in December 2005.

Consequently, transport revenue, including fare and non-fare revenue, increased by 2.9% to HK$4,746 million, compared with HK$4,612 million in 2005. Operating costs before depreciation and amortisation increased by 1.6% to HK$2,650 million from

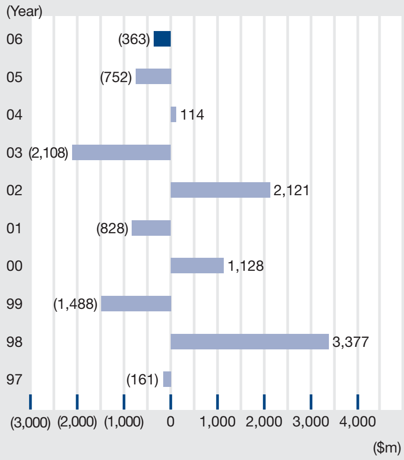
NET RESULTS FROM UNDERLYING BUSINESSES



TOTAL ASSETS



NET CASH INFLOW / (OUTFLOW)



HK$2,608 million in 2005, mainly because of the repair expenditure for the East Rail EMU underframe equipment cracks. Profit generated from KCRC's transport business before depreciation and amortisation increased by 4.6% to HK$2,096 million from HK$2,004 million in 2005. Depreciation and amortisation increased by 1.1% to HK$2,233 million from HK$2,208 million in 2005. As a result, loss before sharing of corporate overheads decreased to HK$137 million from HK$204 million in 2005.

Capital expenditure was HK$414 million in 2006, compared with HK$1,165 million in 2005. The decrease was mainly due to the gradual completion of outstanding works of the Tsim Sha Tsui Extension and Ma On Shan Rail.

PROPERTY

Commercial revenue increased to HK$876 million, up 13.6% from HK$771 million in 2005, mainly because of the improved performance of the duty free business, shopping centres, advertising, exhibitions and station trading. Total operating costs before depreciation and amortisation decreased by 7.3% to HK$177 million from HK$191 million in 2005. Profit generated from KCRC's property related business before depreciation and amortisation increased by 20.5% to HK$699 million from HK$580 million in 2005. Depreciation and amortisation increased by 26.7% to HK$38 million from HK$30 million in 2005, mainly because of the full year operation of the multi-media advertising system. Profit on property development of HK$427 million was recognised in 2006, representing the surplus of initial payments and upfront payments received from developers. After taking into account the property development profit and the unrealised accounting profit resulting from the change in valuation of investment properties of HK$99 million, property related profit before sharing of corporate overheads was HK$1,187 million, an increase of 64.6% from HK$721 million in 2005.

Capital expenditure was HK$74 million in 2006, compared with HK$127 million in 2005. The decrease was mainly due to the completion of the multi-media advertising system.

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 3, 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; and

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

THE ROLES OF THE CHAIRMAN AND THE CHIEF EXECUTIVE OFFICER

The Kowloon-Canton Railway Corporation Ordinance provides for the separation of the posts of the Chairman and the 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 12 and 13. With the exception of the Chief Executive Officer, who replaced the Acting Chief Executive Officer with effect from 1 May 2006, all Members served throughout the year ended 31 December 2006. 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.

BOARD AND COMMITTEE MEETINGS

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

The Board appoints to each Committee (with the exception of the Audit 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. While 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
Mr Michael Tien Chairman Non-Executive Member	16 (16)				2 (2)	
Mr Samuel M H Lai Chief Executive Officer (Acting) Executive Member	9 (9)[1]		4 (4)	4 (3)		2 (2)
Ir James Blake Chief Executive Officer Executive Member	7 (7)[2]		3 (3)	5 (5)		1 (1)
Mr Frederick Ma Si-hang Ex-Officio Member	16 (9)[3]		7 (6)[5]	9 (7)[7]	2 (2)[9]	3 (3)[11]
Dr Sarah Liao Sau-tung Ex-Officio Member	16 (10)[4]			9 (9)[8]	2 (2)[10]	
Mr Vincent Lo Wing-sang Non-Executive Member	16 (12)		7 (6)			
Mr Wan Man-yee Non-Executive Member	16 (12)	4 (4)	4 (2)[6]	9 (9)		
Mr Patrick B Paul Non-Executive Member	16 (10)	4 (4)	3 (1)		2 (2)	
Professor Richard Wong Yue-chim Non-Executive Member	16 (10)			9 (2)		3 (3)
The Honourable Abraham Shek Lai-him Non-Executive Member	16 (14)	4 (1)		9 (4)	2 (1)	
Mr Ng Leung-sing Non-Executive Member	16 (14)		7 (6)			3 (3)

1 *Resigned from the Corporation on 30 April 2006*
2 *Chief Executive Officer with effect from 1 May 2006*
3 *Alternates attended 7 meetings*
4 *Alternates attended 6 meetings*
5 *Alternates attended 6 meetings*
6 *Replaced by Mr Patrick Paul with effect from 1 April 2006*
7 *Alternates attended 7 meetings*
8 *Alternates attended 9 meetings*
9 *Alternates attended 2 meetings*
10 *Representatives attended 2 meetings*
11 *Alternates attended 3 meetings*

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

Expert Member[1]	Property Committee	Capital Projects Committee	Strategic Human Resource Committee	Finance Committee
Mr Philip Nunn	7 (6)			
Mr Alfred Li Hung-kwan				3 (2)
Mr Greg Wong Chak-yan		9 (8)		
Mr Hung Wing-tat		9 (8)		
Mr Wan Man-lung		9 (8)		
Ms Jennifer Lee-shoy		9 (6)		
Ms Anita To Yu Ming-chi			2 (2)	

1 Details of Expert Members are to be found on page 84 in the Report of the Members of the Managing Board.

AUDIT COMMITTEE

During the year, the Audit Committee comprised Mr Patrick B Paul (Chairman), Mr Wan Man-yee and The Hon Abraham Shek Lai-him. All members of the Committee are independent non-executive Members. The Audit Committee met four times during the year. The Committee has at least one member possessing "recent and relevant experience", namely, Mr Patrick B Paul who is a chartered accountant and was formerly Chairman of Pricewaterhouse-Coopers (HK). It can be seen from the Members' biographical details, appearing on pages 12 and 13, 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, reappointment 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 monitors the effectiveness of 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 reference are available from the Company Secretary and are displayed on the Corporation's website, www.kcrc.com. In 2006 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 110.

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 shortlisting 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$50 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$50 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.

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.

THE MERGER

On 11 April 2006 the Government announced that it had signed a Memorandum of Understanding with the MTR Corporation Limited setting out the terms under which the KCR and MTR systems would be merged. The final decision on the rail merger depends on the passage of legislation through the Legislative Council and approval by the minority shareholders of MTR Corporation Limited. As part of the preparatory process leading up to the signing of the definitive transaction documents for the rail merger, liaison committees have been established comprising members from the Government, the MTR Corporation and KCRC to discuss material decisions to be taken by KCRC and the financial impact of such decisions. However, the ultimate decision on such matters still remains with the KCRC. Only when the definitive transaction documents are signed will KCRC be required to seek the prior agreement of the MTR Corporation to implement a material decision.

REPORT OF THE MEMBERS OF THE MANAGING BOARD

The members of the Managing Board have pleasure in submitting herewith their report and audited financial statements for the financial year ended 31 December 2006.

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 17 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) until 30 April), Mr James Blake (Chief Executive Officer with effect from 1 May), 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 12 and 13.

ALTERNATE MEMBERS

Alternate Members in office during 2006 were Mr Martin McKenzie Glass, Mr David Lau Kam-kuen and Mr Alan Lai Nin (alternates for the Secretary for Financial Services and the Treasury), and Mr Joshua Law Chi-kong, Miss Cathy Chu Man-ling, Ms Annie Choi Suk-han, Mr Thomas Chow Tat-ming until 31 August, Mr Philip Yung Wai-hung with effect from 31 August, Mr Patrick Ho Chung-kei and Mr Henry Chan Chi-yan (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; and Miss Jennifer Lee-shoy, a lawyer specialising in Construction Law. Appointed to the Strategic Human Resource Committee is 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. All Expert Members had their appointments renewed in December 2006 until 31 July 2007.

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 77 to 82.

LONG-TERM PLANNING, BUSINESS PLANNING AND FINANCIAL MANAGEMENT FRAMEWORK

Business plans, incorporating triennial forecasts of income and 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 74 to 82.

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 12 to 15.

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 2006 and the state of affairs of the Corporation and of the Group at that date are set out in the financial statements on pages 89 to 158.

FIXED ASSETS

Movements in fixed assets during the year are set out in Note 13 to the financial statements.

SHARE CAPITAL
Details of the Corporation's share capital are set out in Note 30 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 11 to the financial statements.

RETIREMENT BENEFIT SCHEME
Details of the Corporation's retirement benefit scheme are set out in Note 36 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 7 to the financial statements.

INTEREST-BEARING BORROWINGS
Details of the Corporation's interest-bearing borrowings are set out in Note 28 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.

GOING CONCERN
The financial statements on pages 89 to 158 have been prepared on a going concern basis. The Managing Board has approved the Corporation's budget for 2007 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
26 February 2007

CONTENTS

INDEPENDENT AUDITOR'S REPORT

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF THE MANAGING BOARD OF THE KOWLOON-CANTON RAILWAY CORPORATION

We have audited the consolidated financial statements of the Kowloon-Canton Railway Corporation ("the Corporation") set out on pages 89 to 158, which comprise the consolidated and the Corporation balance sheets as at 31 December 2006, the consolidated income statement, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory notes.

Board Members' responsibilities for the financial statements

The Board Members of the Corporation are responsible for the preparation and the true and fair presentation of these financial statements in accordance with Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Kowloon-Canton Railway Corporation Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. This report is made 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.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Corporation's preparation and true and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Board Members, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements give a true and fair view of the state of affairs of the Corporation and of the Group as at 31 December 2006 and of the Group's profit and cash flows for the year then ended in accordance with Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the applicable disclosure requirements of the Hong Kong Companies Ordinance.

KPMG
Certified Public Accountants
8th Floor, Prince's Building
10 Chater Road, Central, Hong Kong
26 February 2007

CONSOLIDATED INCOME STATEMENT

for the year ended 31 December 2006 (Expressed in Hong Kong dollars)

	Note	2006 $ million	2005 $ million
Turnover	3	**5,622**	5,383
Operating costs before depreciation and amortisation	4	**(3,042)**	(3,027)
Operating profit before depreciation and amortisation	5	**2,580**	2,356
Depreciation and amortisation	6	**(2,288)**	(2,258)
Operating profit after depreciation and amortisation		**292**	98
Interest and finance income	7(a)	**499**	525
Interest and finance expenses	7(b)	**(815)**	(823)
Profit from property development		**427**	–
Share of profit of associate		**27**	15
Profit/(loss) before unrealised gains/losses		**430**	(185)
Gains/(losses) on changes in fair value of derivative financial instruments and hedged borrowings	8	**(198)**	400
Net valuation gains on investment properties	13	**99**	171
Profit before taxation		**331**	386
Income tax	9(a)	**(53)**	(69)
Profit for the year wholly attributable to the sole shareholder of the Corporation	10	**278**	317
Dividend payable to the sole shareholder of the Corporation attributable to the year proposed after the balance sheet date	11(a)	**82**	–

The notes on pages 94 to 158 form part of these financial statements.

CONSOLIDATED BALANCE SHEET

at 31 December 2006 (Expressed in Hong Kong dollars)

	Note	2006 $ million	2005 $ million
Assets			
Fixed assets	13		
– Property, plant and equipment		**58,498**	60,127
– Investment properties		**1,378**	1,171
		59,876	61,298
Interest in leasehold land held for own use under operating leases	13	**5,524**	5,645
Construction in progress	14	**13,644**	10,411
Deferred expenditure	15	**1,389**	1,210
Properties under development	16	**449**	1,537
Interest in associate	18	**99**	72
Loans to third party	19	**–**	684
Loan to non-controlled subsidiary	20	**4,022**	3,863
Derivative financial assets	32(e)	**92**	129
Investments	21	**–**	449
Stores and spares	22	**362**	343
Interest and other receivables	23	**571**	717
Cash and cash equivalents	24	**1,947**	3,394
		87,975	89,752
Liabilities			
Interest and other payables	25	**2,459**	2,803
Accrued charges and provisions for capital projects	26	**2,054**	3,038
Lease payable	27	**–**	684
Derivative financial liabilities	32(e)	**540**	361
Interest-bearing borrowings	28	**19,212**	19,474
Deferred income	29	**527**	541
Deferred tax liabilities	9(d)	**3,250**	3,198
		28,042	30,099
Net Assets		**59,933**	59,653
Capital and Reserves			
Share capital	30	**39,120**	39,120
Reserves	31	**20,813**	20,533
Total equity		**59,933**	59,653

Approved and authorised for issue by the Managing Board on 26 February 2007.

Michael Tien
James Blake
Patrick B Paul
Members of the Managing Board

The notes on pages 94 to 158 form part of these financial statements.

CORPORATION BALANCE SHEET

at 31 December 2006 (Expressed in Hong Kong dollars)

	Note	2006 $ million	2005 $ million
Assets			
Fixed assets	13		
– Property, plant and equipment		**58,462**	60,086
– Investment properties		**1,378**	1,171
		59,840	61,257
Interest in leasehold land held for own use under operating leases	13	**5,524**	5,645
Construction in progress	14	**13,644**	10,411
Deferred expenditure	15	**1,389**	1,210
Properties under development	16	**449**	1,537
Interest in associate	18	**42**	42
Loan to non-controlled subsidiary	20	**4,022**	3,863
Derivative financial assets	32(e)	**92**	129
Investments	21	**–**	449
Stores and spares	22	**362**	343
Interest and other receivables	23	**578**	707
Cash and cash equivalents	24	**1,795**	3,270
		87,737	88,863
Liabilities			
Interest and other payables	25	**2,307**	2,664
Accrued charges and provisions for capital projects	26	**2,054**	3,038
Derivative financial liabilities	32(e)	**540**	361
Interest-bearing borrowings	28	**19,212**	19,474
Deferred income	29	**492**	501
Deferred tax liabilities	9(d)	**3,251**	3,198
		27,856	29,236
Net Assets		**59,881**	59,627
Capital and Reserves			
Share capital	30	**39,120**	39,120
Reserves	31	**20,761**	20,507
Total equity		**59,881**	59,627

Approved and authorised for issue by the Managing Board on 26 February 2007.

Michael Tien
James Blake
Patrick B Paul
Members of the Managing Board

The notes on pages 94 to 158 form part of these financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December 2006 (Expressed in Hong Kong dollars)

	Note	**2006 $ million**	2005 $ million
Total equity at 1 January		**59,653**	59,494
Net expenses for the year recognised directly in equity:			
Deficit on revaluation of available-for-sale securities	31	**–**	(15)
Net profit for the year	31	**278**	317
Revaluation deficit transferred to the income statement on redemption and disposal of available-for-sale securities	31	**2**	29
Dividend approved and paid during the year	11(b)	**–**	(172)
Total equity at 31 December		**59,933**	59,653

The notes on pages 94 to 158 form part of these financial statements.

CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December 2006 (Expressed in Hong Kong dollars)

	Note	2006 $ million	2005 $ million
Operating activities			
Net cash inflow from operations	33	**2,664**	2,408
Net cash inflow from property development		**1,505**	340
Hong Kong profits tax paid		**(1)**	(1)
Net cash inflow from operating activities		**4,168**	2,747
Investing activities			
Decrease/(increase) in deposits with banks with maturity more than three months when placed		**1,084**	(615)
Payments for capital expenditure:			
–East Rail Extensions project		**(2,038)**	(2,821)
–Kowloon Southern Link project		**(1,344)**	(709)
–other capital projects and purchase of fixed assets		**(1,140)**	(1,459)
Interest received		**237**	750
Dividend received from associate		**–**	33
Repayment from/(loan to) non-controlled subsidiary		**38**	(84)
Loan to associate		**–**	(33)
Receipts on sales of fixed assets		**5**	4
Receipts on redemption and disposal of available-for-sale securities		**411**	3,311
Net cash outflow from investing activities		**(2,747)**	(1,623)
Net cash inflow before financing		**1,421**	1,124
Financing activities			
Net cash outflow on repayment of loans		**(298)**	(279)
Dividend paid		**–**	(172)
Interest paid		**(1,388)**	(1,392)
Net cash outflow relating to derivative financial instruments		**(77)**	(13)
Finance expenses paid		**(21)**	(20)
Net cash outflow from financing activities		**(1,784)**	(1,876)
Net decrease in cash and cash equivalents		**(363)**	(752)
Cash and cash equivalents at 1 January		**1,839**	2,591
Cash and cash equivalents at 31 December		**1,476**	1,839
Analysis of the balances of cash and cash equivalents			
Cash at bank and in hand	24	**71**	42
Deposits with banks with maturity of less than three months when placed	24	**1,405**	1,797
		1,476	1,839

The notes on pages 94 to 158 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.

(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 42.

(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.

2 SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

(c) Basis of consolidation *(continued)*

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

Subsidiaries are entities controlled by the Group. Control exists when the Group has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable are taken into account.

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 Group's 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;

(ii) changes in fair value of other investments are recognised directly in the investments revaluation reserve, except for related impairment losses and foreign exchange gains and losses of monetary items such as debt securities, 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 policies, the Group does not hold or issue derivative financial instruments for trading purposes.

All the Group's derivative financial instruments are recognised initially as derivative financial assets or liabilities at fair value. The fair value of each of the derivative financial instruments is remeasured at each balance sheet date, with any resultant gain or loss recognised immediately in the income statement, except where the derivatives qualify for cash flow hedge accounting, in which case recognition of any resultant gain or loss depends on the item being hedged as covered by the policy statement below.

(i) Cash flow hedges

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.

Changes in fair value of currency swaps that hedge recognised monetary liabilities in foreign currencies are recognised in the income statement as required under HKAS 39.

2 SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

(g) Derivative financial assets and liabilities *(continued)*

(ii) Fair value hedges

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.

Changes in fair value of derivative financial instruments designated as hedging instruments in a fair value hedge are recognised in the income statement.

When a hedging relationship ceases to meet the requirements of hedge accounting, any adjustment to the carrying amount of the then hedged item is amortised to the income statement over the remaining life of the item based on a recalculated effective interest rate at the date amortisation begins.

(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.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

2 SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

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

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, which is below $20,000 per item or expected to be fully used within one year, is expensed to the income statement as incurred.

(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.

2 SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

(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:

	<u>No. of years</u>
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	5–15
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.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

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 carried at cost, an impairment loss is measured as the difference between the asset's carrying amount and the estimated future cash flows (taking into account bad and doubtful debts), discounted at the current market rate of return of a similar financial asset where the effect of discounting is material.
– For loans to third party and loan to non-controlled subsidiary carried at amortised cost, 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 there are no fixed repayment terms.

2 SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

(l) Impairment of assets *(continued)*

(i) Impairment of financial assets *(continued)*

- 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, an impairment loss relating to the cumulative loss that had been capitalised to construction in progress or deferred expenditure is not 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.

(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;
- interest in leasehold land held for own use under operating leases;
- 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.

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 *(continued)*

– 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 related assets are completed and ready for their intended use at which time the costs begin to be amortised in accordance with the relevant policies.

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.

2 SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

(o) Property development *(continued)*

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 the 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.

(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.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

2 SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

(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, which is equivalent to cost, and thereafter is stated at 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, interest and other receivables are stated at cost less impairment losses, if any.

(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 portion of interest-bearing borrowings, which is the subject of a fair value hedge, 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, other payables are stated at cost.

2 SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

(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.

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

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

2 SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

(z) Income tax *(continued)*

- 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.

(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.

2 SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

(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.

(ae) Interest and finance income/expenses

(i) Interest and finance income includes:

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

(ii) The Group's interest and finance income arising from non-derivative financial assets 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.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

2 SIGNIFICANT ACCOUNTING POLICIES *(CONTINUED)*

(ae) Interest and finance income/expenses *(continued)*

Interest and finance expenses include:

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

(iii) The Group's interest and finance expenses arising from non-derivative financial liabilities 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.

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

3 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:

	2006 $ million	2005 $ million
Transport services		
Passenger services		
– East Rail	**3,780**	3,670
– West Rail and Light Rail	**922**	890
Freight services	**44**	52
	4,746	4,612
Property services	**876**	771
	5,622	5,383

4 OPERATING COSTS BEFORE DEPRECIATION AND AMORTISATION

	2006 $ million	2005 $ million
Staff costs		
– Gross amount including retirement costs of $136 million (2005: $135 million) after a forfeiture of unvested contributions of $1 million (2005: $2 million)	**2,092**	2,068
– Staff costs capitalised	**(549)**	(547)
	1,543	1,521
Electricity and fuel	**484**	495
Repairs and maintenance	**274**	265
Stores and spares consumed	**217**	181
General supplies	**31**	33
Government rent and rates	**78**	82
Octopus cards usage fees	**38**	36
Cost of services acquired	**148**	150
Property ownership and management expenses	**66**	84
Expenses to prepare for the proposed merger with MTRCL (including staff costs of $2 million)	**20**	–
Others	**143**	180
	3,042	3,027

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

5 OPERATING PROFIT BEFORE DEPRECIATION AND AMORTISATION

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

	2006 $ million	2005 $ million
Fixed assets written off on disposal	**24**	43
Auditors' remuneration		
– Audit services	**4**	4
– Tax compliance services	**–**	1
– Advisory services on control documentation	**1**	4
Operating lease charges (minimum lease payments)		
– Hire of plant and machinery	**28**	28
– Rental of property	**9**	8
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	**26**	25
and after crediting:		
Rentals receivable from operating leases less direct outgoings of $20 million (2005: $16 million) (including contingent rentals of $63 million (2005: $39 million))	**756**	642
Rentals receivable from investment properties less direct outgoings of $11 million (2005: $14 million)	**75**	38

5 OPERATING PROFIT BEFORE DEPRECIATION AND AMORTISATION *(CONTINUED)*

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

	2006 **$'000**	2005 $'000
Chairman		
Mr Michael P S Tien	**220**	220
Members		
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**	110
Mr Patrick B Paul	**110**	110
The Honourable Abraham L H Shek	**110**	110
Mr M Y Wan	**110**	110
Professor Richard Y C Wong	**110**	110
	1,100	1,100

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

5 OPERATING PROFIT BEFORE DEPRECIATION AND AMORTISATION *(CONTINUED)*

(c) Emoluments of the Chief Executive Officer and Executive Directors who are not Members of the Managing Board include fixed remuneration which comprises base pay, allowances and gratuities; benefits-in-kind; retirement benefit scheme contributions and variable remuneration. Variable remuneration is paid based on the overall performance of the Corporation and the individual concerned measured against the pre-defined threshold target approved by the Managing Board. Details of emoluments are shown below:

	2006 $ million				2005 $ million			
	Fixed remuneration and benefits-in-kind	Contribution to retirement benefit scheme	Variable* remuneration	Total	Fixed remuneration and benefits-in-kind	Contribution to retirement benefit scheme	Variable* remuneration	Total
Mr James Blake ** (Chief Executive Officer)	3.00	–	1.19	4.19	–	–	–	–
Mr K K Lee (Senior Director-Capital Projects)	3.12	0.32	0.91	4.35	3.05	0.32	0.79	4.16
Mr Y T Li (Senior Director-Transport)	3.22	0.29	0.81	4.32	3.11	0.28	0.71	4.10
Mr Daniel C Lam (Director-Property)	3.24	0.01	0.92	4.17	3.25	0.01	0.82	4.08
Mr Lawrence C P Li (Director-Finance)	2.28	0.22	0.44	2.94	2.18	0.21	0.39	2.78
Mrs Mimi Cunningham (Director-Human Resource)	3.18	0.01	0.86	4.05	3.03	0.01	0.76	3.80
Mr Samuel M H Lai # (Acting Chief Executive Officer)	3.04	0.13	–	3.17	3.58	0.38	0.95	4.91
Mr Ian M Thoms @ (Director-West Rail)	–	–	–	–	1.96	0.01	–	1.97
	21.08	0.98	5.13	27.19	20.16	1.22	4.42	25.80

* *Variable remuneration mainly comprises amounts withheld from employees' basic salary package and released for payment upon their satisfactory performance being confirmed by the Managing Board. The total variable remuneration is calculated according to a formula devised when the scheme was introduced at the request of the Managing Board.*

** *Mr James Blake joined the Corporation on 22 March 2006.*

\# *Mr Samuel M H Lai's remuneration includes an end-of-service payment of $1.1 million. He left the Corporation on 1 May 2006.*

@ *Mr Ian M Thoms retired on 1 July 2005.*

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

6 DEPRECIATION AND AMORTISATION

	2006 $ million	2005 $ million
Depreciation:		
– assets leased out under operating leases	32	32
– other assets	2,141	2,111
– depreciation charge capitalised	(4)	(3)
	2,169	2,140
Amortisation:		
– amortisation of interest of leasehold land held for own use under operating leases	119	118
	2,288	2,258

7 INTEREST AND FINANCE INCOME/EXPENSES

(a) Interest and finance income

	2006 $ million	2005 $ million
Interest income from deposits	143	128
Interest income from investments	4	60
Interest income from loans to third party	–	51
Interest income from loan to non-controlled subsidiary	320	266
Interest income from non-derivative financial assets	467	505
Realised gains arising from derivative financial instruments	32	85
Exchange gains (net)	–	33
	499	623
Less: Amount capitalised *	–	(98)
	499	525

* *Interest income capitalised for 2005 was earned at average interest rates ranging between 2.26% and 4.20% per annum.*

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

7 INTEREST AND FINANCE INCOME/EXPENSES *(CONTINUED)*

(b) Interest and finance expenses

	2006 $ million	2005 $ million
Interest expenses on lease payable	–	50
Interest expenses on other loans	1,407	1,394
Finance expenses	9	18
Interest and finance expenses on non-derivative financial liabilities	1,416	1,462
Realised losses arising from derivative financial instruments	126	106
Exchange loss (net)	40	–
Realised losses on redemption and disposal of investments (including $2 million (2005: $29 million) transferred from the investments revaluation reserve)	3	35
	1,585	1,603
Less: Amount capitalised #	(770)	(780)
	815	823

 # Interest expenses capitalised were charged at average interest rates ranging between 7.10% (2005: 6.83%) and 7.98% (2005: 7.54%) per annum.

8 GAINS/(LOSSES) ON CHANGES IN FAIR VALUE OF DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGED BORROWINGS

	2006 $ million	2005 $ million
Net gain/(loss) arising from derivative financial instruments	(216)	227
Net gain arising from hedged interest-bearing borrowings	18	173
	(198)	400

9 INCOME TAX

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

	2006 $ million	2005 $ 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	**52**	68
	53	69

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 $10,800 million at 31 December 2006 (2005: approximately $9,700 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:

	2006 $ million	2005 $ million
Profit before taxation	**331**	386
Tax on accounting profit before taxation at 17.5%	**58**	67
Tax effect of non-deductible expenses	**31**	33
Tax effect of non-taxable revenue	**(36)**	(31)
Actual tax expense	**53**	69

(c) Current tax in the balance sheet represents:

	Group		Corporation	
	2006 $ million	2005 $ million	2006 $ million	2005 $ million
Provision for Hong Kong profits tax for the year	**1**	1	**–**	–
Provisional profits tax paid	**(1)**	(1)	**–**	–
	–	–	**–**	–

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

9 INCOME TAX *(CONTINUED)*

(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:

The Group

	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 2005	(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
At 1 January 2006	**(1,707)**	**4,828**	**77**	**3,198**
Charged/(credited) to the income statement	**(189)**	**224**	**17**	**52**
At 31 December 2006	**(1,896)**	**5,052**	**94**	**3,250**

The Corporation

	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 2005	(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
At 1 January 2006	**(1,707)**	**4,828**	**77**	**3,198**
Charged/(credited) to the income statement	**(189)**	**225**	**17**	**53**
At 31 December 2006	**(1,896)**	**5,053**	**94**	**3,251**

The deferred tax assets and liabilities as at 31 December 2006 are expected to be recovered or settled after 12 months.

10 PROFIT FOR THE YEAR WHOLLY ATTRIBUTABLE TO THE SOLE SHAREHOLDER OF THE CORPORATION

Of the consolidated profit for the year amounting to $278 million (2005: $317 million), $252 million (2005: $336 million) has been dealt with in the financial statements of the Corporation.

11 PROPOSED DIVIDEND

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

	2006 **$ million**	2005 $ million
Final dividend proposed after the balance sheet date of $209.61 per share (2005: nil per share)	**82**	–

The final dividend proposed after the balance sheet date has not been recognised as a liability at the balance sheet date.

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

	2006 **$ million**	2005 $ million
Final dividend in respect of the previous financial year, approved and paid during the year, of nil per share (2005: $439.67 per share)	**–**	172

12 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.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

12 SEGMENTAL REPORTING *(CONTINUED)*

2006

Operating results

	Transport services segment $ million	Property segment $ million	Consolidated total $ million
Revenue	4,746	876	5,622
Operating costs before depreciation and amortisation	(2,690)	(137)	(2,827)
Inter-segment charges [1]	40	(40)	–
Depreciation and amortisation	(2,233)	(38)	(2,271)
Result after depreciation and amortisation	(137)	661	524
Profit from property development	–	427	427
Net valuation gains on investment properties	–	99	99
Result	(137)	1,187	1,050
Unallocated corporate expenses, depreciation and amortisation			(232)
Interest and finance income			499
Interest and finance expenses			(815)
Share of profit of associate			27
Losses on changes in fair value of derivative financial instruments and hedged borrowings			(198)
Income tax			(53)
Profit after taxation			278

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

12 SEGMENTAL REPORTING *(CONTINUED)*

Assets and liabilities

	Transport services segment $ million	Property segment $ million	Consolidated total $ million
Assets	63,786	2,049	65,835
Properties under development	–	449	449
Interest in associate	–	–	99
Railways under construction @	–	–	14,722
Unallocated assets #	–	–	6,870
	63,786	2,498	87,975
Liabilities	339	714	1,053
Deferred income	325	202	527
Unallocated liabilities *	–	–	26,462
	664	916	28,042

@ *Comprising construction and land costs of Lok Ma Chau and Kowloon Southern Link ($13,333 million) and planning and design costs of Shatin to Central Link and Express Rail Link/Northern Link ($1,389 million).*

Comprising corporate assets and construction in progress for corporate office ($317 million), derivative financial assets ($92 million), loan to non-controlled subsidiary ($4,022 million), interest and other receivables ($492 million) and cash and cash equivalents ($1,947 million).

* *Comprising interest-bearing borrowings ($19,212 million), accrued charges and provisions for capital projects ($1,983 million), interest and other payables ($1,477 million), deferred tax liabilities ($3,250 million) and derivative financial liabilities ($540 million).*

Other information

	Transport services segment $ million	Property segment $ million	Consolidated total $ million
Capital expenditure			
– Operational railways	414	74	488
– Railways under construction	–	–	2,817
– Unallocated capital expenditure	–	–	12
	414	74	3,317

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

12 SEGMENTAL REPORTING *(CONTINUED)*

2005

Operating results

	Transport services segment $ million	Property segment $ million	Consolidated total $ million
Revenue	4,612	771	5,383
Operating costs before depreciation and amortisation	(2,646)	(153)	(2,799)
Inter-segment charges [1]	38	(38)	–
Depreciation and amortisation	(2,208)	(30)	(2,238)
Result after depreciation and amortisation	(204)	550	346
Net valuation gains on investment properties	–	171	171
Result	(204)	721	517
Unallocated corporate expenses, depreciation and amortisation			(248)
Interest and finance income			525
Interest and finance expenses			(823)
Share of profit of associate			15
Gains on changes in fair value of derivative financial instruments and hedged borrowings			400
Income tax			(69)
Profit after taxation			317

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

12 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 and Express Rail Link/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 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 2005	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/(reversal of over-accruals)	–	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
At 1 January 2006	**1,171**	**20,225**	**29,447**	**9,271**	**11,372**	**71,486**	**5,985**
Transfer from construction in progress	**112**	**11**	**41**	**4**	**265**	**433**	**7**
Additions/(reversal of over-accruals)	**–**	**(6)**	**199**	**1**	**54**	**248**	**(9)**
Disposals	**(4)**	**(20)**	**(1)**	**(3)**	**(49)**	**(77)**	**–**
Fair value adjustment	**99**	**–**	**–**	**–**	**–**	**99**	**–**
At 31 December 2006	**1,378**	**20,210**	**29,686**	**9,273**	**11,642**	**72,189**	**5,983**
Accumulated depreciation and amortisation:							
At 1 January 2005	–	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
At 1 January 2006	**–**	**847**	**2,015**	**2,519**	**4,807**	**10,188**	**340**
Charge for the year	**–**	**473**	**610**	**274**	**816**	**2,173**	**119**
Written back on disposals	**–**	**(2)**	**–**	**(3)**	**(43)**	**(48)**	**–**
At 31 December 2006	**–**	**1,318**	**2,625**	**2,790**	**5,580**	**12,313**	**459**
Carrying amounts:							
At 31 December 2006	**1,378**	**18,892**	**27,061**	**6,483**	**6,062**	**59,876**	**5,524**
At 31 December 2005	1,171	19,378	27,432	6,752	6,565	61,298	5,645

13 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 2005	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/(reversal of over-accruals)	–	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
At 1 January 2006	**1,171**	**20,225**	**29,447**	**9,271**	**11,321**	**71,435**	**5,985**
Transfer from construction in progress	**112**	**11**	**41**	**4**	**265**	**433**	**7**
Additions/(reversal of over-accruals)	**–**	**(6)**	**199**	**1**	**54**	**248**	**(9)**
Disposals	**(4)**	**(20)**	**(1)**	**(3)**	**(49)**	**(77)**	**–**
Fair value adjustment	**99**	**–**	**–**	**–**	**–**	**99**	**–**
At 31 December 2006	**1,378**	**20,210**	**29,686**	**9,273**	**11,591**	**72,138**	**5,983**
Accumulated depreciation and amortisation:							
At 1 January 2005	–	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
At 1 January 2006	**–**	**847**	**2,015**	**2,519**	**4,797**	**10,178**	**340**
Charge for the year	**–**	**473**	**610**	**274**	**811**	**2,168**	**119**
Written back on disposals	**–**	**(2)**	**–**	**(3)**	**(43)**	**(48)**	**–**
At 31 December 2006	**–**	**1,318**	**2,625**	**2,790**	**5,565**	**12,298**	**459**
Carrying amounts:							
At 31 December 2006	**1,378**	**18,892**	**27,061**	**6,483**	**6,026**	**59,840**	**5,524**
At 31 December 2005	1,171	19,378	27,432	6,752	6,524	61,257	5,645

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(Expressed in Hong Kong dollars)

13 FIXED ASSETS AND INTEREST IN LEASEHOLD LAND HELD FOR OWN USE UNDER OPERATING LEASES *(CONTINUED)*

(c) Permanent way principally comprises the cost 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.

(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 2006 were remeasured on an open market basis, by either making reference to comparable sales in the relevant locality, or otherwise, by capitalising the net income with due allowance for reversionary income potential. The valuations were carried out by an independent firm of surveyors, CB Richard Ellis Limited, 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 net fair value gain of $99 million (2005: $171 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:

	2006		2005	
	Gross carrying amount $ million	**Related accumulated depreciation $ million**	Gross carrying amount $ million	Related accumulated depreciation $ million
Goods yard at Hung Hom Bay	**84**	**13**	85	11
Hung Hom Station Car Park	**55**	**25**	56	24
Offices at Hung Hom Station	**23**	**7**	23	6
Offices at Hung Hom freight building	**6**	**1**	6	1
Citylink Plaza at Sha Tin Station	**144**	**68**	144	63
Goods yard at Mongkok Station	**45**	**8**	45	7
Shops at stations	**802**	**93**	764	81
Mobile phone coverage system	**84**	**48**	84	43
Trackside Villas	**36**	**9**	30	7
	1,279	**272**	1,237	243

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.

13 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:

	2006	2005
	$ million	$ million
Within one year	**896**	663
After one year but within five years	**1,739**	704
After five years	**155**	15
	2,790	1,382

(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.

As at 31 December 2006, a portion of the Group's and Corporation's assets (including assets replaced during the lease periods) with a total cost of $10,163 million (2005: $11,919 million) and net book value of $5,572 million (2005: $7,579 million) is covered by eight arrangements (2005: nine arrangements). Five arrangements (2005: 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 enjoy substantially the same rights to their use as before the arrangements were entered into, no adjustment has been made to fixed assets. As a result of the eight arrangements (2005: nine arrangements), the Group and Corporation have received cash of $10,805 million (2005: $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 $10,292 million (2005: $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.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

13 FIXED ASSETS AND INTEREST IN LEASEHOLD LAND HELD FOR OWN USE UNDER OPERATING LEASES *(CONTINUED)*

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 $24 million (2005: $39 million) recognised for the year has been included in the transport services segment in the income statement.

(j) Included in additions are amounts paid and payable or received and receivable to the Government by the Corporation in respect of the following:

- $21 million (2005: $18 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.

- Refund of $25 million (accrual for 2005: $50 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 2006, 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)	Increase in depreciation charge for the year $ million
Signalling system for Tsim Sha Tsui Extension	10	5	7
Permanent way – East Rail	17	12	5
			12

(l) The carrying value of the Group's and Corporation's interest in leasehold land held in Hong Kong is $5,497 million (2005: $5,617 million) under medium-term leases (less than 50 years) and $27 million (2005: $28 million) under long-term leases (50 years or above).

14 CONSTRUCTION IN PROGRESS

Construction in progress comprises:

(a) The Group

2006

	Kowloon Southern Link $ million	East Rail Extensions $ million	Other assets $ million	Total construction in progress $ million
Balance as at 1 January 2006	1,307	8,648	456	10,411
Costs incurred during the year	1,533	1,845	295	3,673
Transfer to fixed assets or leasehold land	–	–	(440)	(440)
Balance as at 31 December 2006	2,840	10,493	311	13,644

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

(b) The Corporation

2006

	Kowloon Southern Link $ million	East Rail Extensions $ million	Other assets $ million	Total construction in progress $ million
Balance as at 1 January 2006	1,307	8,648	456	10,411
Costs incurred during the year	1,533	1,845	295	3,673
Transfer to fixed assets or leasehold land	–	–	(440)	(440)
Balance as at 31 December 2006	2,840	10,493	311	13,644

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

14 CONSTRUCTION IN PROGRESS *(CONTINUED)*

(b) The Corporation (continued)

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

(c) As at 31 December 2006, land resumption costs and other costs totalling approximately $632 million (2005: $612 million) and $51 million (2005: $24 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:

– $46 million (2005: $13 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.

– $19 million (2005: $9 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.

(e) The costs incurred during the year are arrived at after crediting $55 million (2005: $23 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 20).

15 DEFERRED EXPENDITURE

Deferred expenditure comprises:

2006

	Shatin to Central Link $ million	Express Rail Link/ Northern Link $ million	Total deferred expenditure $ million
Balance as at 1 January 2006	**1,188**	**22**	**1,210**
Expenditure during the year	**–**	**179**	**179**
Balance as at 31 December 2006	**1,188**	**201**	**1,389**

2005

	Kowloon Southern Link $ million	Shatin to Central Link $ million	Express Rail Link/ Northern Link $ million	Total deferred expenditure $ million
Balance as at 1 January 2005	279	1,178	4	1,461
Expenditure during the year	569	10	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

(a) The planning, design and construction of the Shatin to Central Link was suspended in 2005 pending the announcement by the Government of its decision on how and by whom the Shatin to Central Link, to which the Government remains committed in principle, would in fact be constructed. The Corporation's expenditure on the Shatin to Central Link is carried in the balance sheet at cost and if the Corporation in due course constructs the Shatin to Central Link, this amount will form part of the final cost of the completed project. If, however, another party were to construct the Shatin to Central Link, it is uncertain whether the Corporation would be able to recover any or all of the expenditure it has incurred on the project, and any shortfall in recovery would be written off to the Corporation's income statement in the appropriate future accounting period.

(b) As at 31 December 2006, land related costs totalling approximately $6 million (2005: $6 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.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

16 PROPERTIES UNDER DEVELOPMENT

	2006 **$ million**	2005 $ million
Balance as at 1 January	**1,537**	1,892
Expenditure incurred during the year	**6**	35
Amounts recovered during the year	**(1,094)**	(390)
Balance as at 31 December	**449**	1,537

The balance of expenditure on properties under development is mainly related to the property enabling works for development sites at Che Kung Temple Station and Tai Wai Station. During the year, the Corporation entered into a joint venture agreement with a property developer for property developments at Tai Wai Maintenance Centre and recovered from the joint venture property developer the expenditure incurred to date for site development. The other development projects will be put out to tender from 2007 onwards in accordance with the master tender programme as agreed with the Government.

Included in the amounts recovered is a cost recovery of nil (2005: $88 million) from the Government in respect of public transport interchange and property development enabling works.

17 INVESTMENTS IN SUBSIDIARIES

	Corporation 2006 $ million	Corporation 2005 $ 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
Property Management				
Manlai Court Property Management Company Limited #	Hong Kong	25,500 'A' 24,500 'B'	$1 $1	100% Nil
Sun Tuen Mun Centre Management Company Limited	Hong Kong	25,000 'A' 25,000 'B'	$1 $1	100% 100%
Royal Ascot Management Company Limited	Hong Kong	25,000 'A' 25,000 'B'	$1 $1	100% 100%
Hanford Garden Property Management Company Limited	Hong Kong	10,000	$1	100%
Pierhead Garden Management Company Limited	Hong Kong	25,000 'A' 25,000 'B'	$1 $1	100% 100%
The Metropolis Management Company Limited	Hong Kong	25,500 'A' 24,500 'B'	$1 $1	100% Nil
Capital System Limited ##	Hong Kong	5,000	$1	100%
Asset Leasing				
Buoyant Asset Limited	Hong Kong	100	$10	100%
Advanced Asset Limited	Hong Kong	100	$10	100%
Quality Asset Limited	Hong Kong	100	$10	100%
Kasey Asset Limited	Hong Kong	100	$10	100%
Circuit Asset Limited	Hong Kong	100	$10	100%
Shining Asset Limited	Hong Kong	100	$10	100%
Fluent Asset Limited	Hong Kong	100	$10	100%

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

17 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
Kudos Asset Limited [&]	Hong Kong	100	$10	100%
Unique Asset Limited [&]	Hong Kong	100	$10	100%
Bowman Asset Limited	Cayman Islands	1,000	US$1	100%
Statesman Asset Limited	Cayman Islands	1,000	US$1	100%
Interwind Asset Limited [@]	Hong Kong	100	$10	100%
Hardy Asset Limited [@]	Hong Kong	100	$10	100%
Roving Asset Limited [@]	Hong Kong	100	$10	100%
Swanky Asset Limited [@]	Hong Kong	100	$10	100%
Telecommunication				
V-Connect Limited	Hong Kong	100	$10	100%
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

[#] *At 31 December 2006, the subsidiary is in the process of winding up as a result of the termination of the business of property management in Manlai Court.*

[##] *At 31 December 2006, the subsidiary is in the process of winding up as it is no longer serving any commercial function.*

[&] *At 31 December 2006, the subsidiaries are in the process of winding up as the concerned leasing transaction was terminated in 2006.*

[@] *At 31 December 2006, the subsidiaries are in the process of de-registration as the proposed leasing transactions have not materialised.*

* *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:

	2006 $ million	2005 $ million
Assets	**4,046**	3,861
Liabilities	**4,048**	3,863
Equity	**(2)**	(2)
Turnover	**–**	–
Profit/(loss) after taxation for the year	**–**	–

18 INTEREST IN ASSOCIATE

The interest in associate is as follows:

	Group		Corporation	
	2006	2005	**2006**	2005
	$ million	$ million	**$ million**	$ million
Unlisted shares, at cost	**–**	–	**9**	9
Share of net assets	**66**	39	**–**	–
Loan to associate	**33**	33	**33**	33
	99	72	**42**	42

Details of the associate, which is incorporated and operates in Hong Kong, are as follows:

Name of company	**Number of issued and fully paid ordinary shares**	**Par value of shares**	**Percentage of shares held**
Octopus Holdings Limited	42,000,000	$1	22.1%

The Corporation and four other local transport companies (including the MTR Corporation Limited ("MTRCL")) entered into an agreement in 1994 to develop and operate the Octopus cards system through a central body called Octopus Cards Limited.

On 21 October 2005, the Corporation and the other shareholders of Octopus Cards Limited divested themselves of all their shares in Octopus Cards Limited to a new holding company, Octopus Holdings Limited, in consideration for the issue to them of new shares in Octopus Holdings Limited.

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 received an interest payment from Octopus Holdings Limited, amounting to $2 million (2005: nil).

During the year, the Group made payments to Octopus Cards Limited, amounting to $38 million (2005: $36 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 (2005: $7 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)

18 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 is as follows:

	2006 $ million 100%	2006 $ million Group's effective interest (22.1%)	2005 $ million 100%	2005 $ million Group's effective interest (22.1%)
Assets	**2,180**	**482**	1,833	405
Liabilities	**1,882**	**416**	1,653	366
Equity	**298**	**66**	180	39
Turnover	**405**	**90**	354	78
Profit after tax for the year	**118**	**27**	69	15

19 LOANS TO THIRD PARTY

The loans in 2005 related to one of the lease arrangements entered into by the Group and the Corporation. Under such lease arrangement, the future lease payments were to be funded by the interest earned on certain loans to third party and the repayment of those loans. In 2006, the lease arrangement was terminated and those loans to third party were offset against the termination amount payable by the Group and the Corporation under the agreements for terminating the lease.

20 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.

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.

20 LOAN TO NON-CONTROLLED SUBSIDIARY *(CONTINUED)*

The loan to non-controlled subsidiary is expected to be recovered as follows:

	2006 $ million	2005 $ million
Within one year	**153**	1,202
After one year	**3,869**	2,661
	4,022	3,863

21 INVESTMENTS

Investments comprise:

	2006 $ million	2005 $ million
Available-for-sale debt securities		
– Listed outside Hong Kong	**–**	31
– Unlisted	**–**	369
Interest-bearing deposits temporarily placed with the custodian bank	**–**	49
Total fair value of investments	**–**	449
Total market value of listed investments	**–**	31

22 STORES AND SPARES

Stores and spares are expected to be consumed as follows:

	2006 $ million	2005 $ million
Within one year	**133**	159
After one year	**229**	184
	362	343

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

23 INTEREST AND OTHER RECEIVABLES

(a) Interest and other receivables comprise:

	Group		Corporation	
	2006	2005	**2006**	2005
	$ million	$ million	**$ million**	$ million
Interest receivable	**8**	42	**8**	26
Amounts due from subsidiaries	**–**	–	**12**	10
Amount due from the Government	**312**	432	**312**	432
Debtors, deposits, prepayments and revenue in arrears	**251**	243	**246**	239
	571	717	**578**	707

The amount due from the Government represents amounts receivable for certain essential public infrastructure works and other works along the railways undertaken on behalf of the Government pursuant to the respective entrustment agreements and project agreements with the Government.

(b) Interest and other receivables are expected to be recovered as follows:

	Group		Corporation	
	2006	2005	**2006**	2005
	$ million	$ million	**$ million**	$ million
Within one year	**531**	651	**538**	645
After one year	**40**	66	**40**	62
	571	717	**578**	707

(c) Included in interest and other receivables are debtors with the following ageing analysis :

	Group		Corporation	
	2006	2005	**2006**	2005
	$ million	$ million	**$ million**	$ million
Current	**440**	573	**447**	563
Less than one month overdue	**2**	3	**2**	3
One to three months overdue	**3**	3	**3**	3
More than three months overdue	**1**	5	**1**	5
Total debtors	**446**	584	**453**	574
Deposits, prepayments and revenue in arrears	**125**	133	**125**	133
	571	717	**578**	707

23 INTEREST AND OTHER RECEIVABLES *(CONTINUED)*

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.

24 CASH AND CASH EQUIVALENTS

Cash and cash equivalents comprise :

	Group		Corporation	
	2006	2005	**2006**	2005
	$ million	$ million	**$ million**	$ million
Deposits with banks				
– Within three months to maturity when placed	**1,405**	1,797	**1,337**	1,673
– More than three months to maturity when placed	**471**	1,555	**387**	1,555
Cash at bank and in hand	**71**	42	**71**	42
Cash and cash equivalents in the balance sheets	**1,947**	3,394	**1,795**	3,270
Less: deposits with banks with more than three months to maturity when placed	**(471)**	(1,555)		
Cash and cash equivalents in the consolidated cash flow statement	**1,476**	1,839		

25 INTEREST AND OTHER PAYABLES

(a) Interest and other payables comprise:

	Group		Corporation	
	2006	2005	**2006**	2005
	$ million	$ million	**$ million**	$ million
Interest payable	**462**	486	**462**	470
Deposits and advances	**1,151**	1,075	**998**	954
Creditors and accrued charges	**846**	1,242	**842**	1,236
Amounts due to subsidiaries	**–**	–	**5**	4
	2,459	2,803	**2,307**	2,664

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

25 INTEREST AND OTHER PAYABLES *(CONTINUED)*

(b) Interest and other payables are expected to be settled as follows:

	Group		Corporation	
	2006	2005	**2006**	2005
	$ million	$ million	**$ million**	$ million
Within one year	**1,697**	2,132	**1,570**	1,993
After one year	**762**	671	**737**	671
	2,459	2,803	**2,307**	2,664

(c) Included in interest and other payables are creditors with the following ageing analysis:

	Group		Corporation	
	2006	2005	**2006**	2005
	$ million	$ million	**$ million**	$ million
Due within one month or on demand	**557**	641	**558**	645
Due between one month to three months	**219**	234	**219**	218
Due between three months to six months	**43**	45	**43**	45
Due after six months	**199**	255	**199**	255
Total creditors	**1,018**	1,175	**1,019**	1,163
Deposits and advances	**1,151**	1,075	**998**	954
Accrued charges	**290**	553	**290**	547
	2,459	2,803	**2,307**	2,664

26 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 $1,361 million (2005: $1,584 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 $90 million and reversed or utilised amounts totalling $566 million. As of 31 December 2006, provision for claims and land premium, resumption and associated costs totalled $1,460 million.

26 ACCRUED CHARGES AND PROVISIONS FOR CAPITAL PROJECTS *(CONTINUED)*

Accrued charges and provisions for capital projects are expected to be settled or utilised as follows:

	2006 $ million	2005 $ million
Within one year	**1,080**	1,814
After one year	**974**	1,224
	2,054	3,038

27 LEASE PAYABLE

The lease payable in 2005 related to one of the lease arrangements entered into by the Group and the Corporation. Under such lease arrangement, the lease payable was to be funded by the interest earned on certain loans to a third party and the repayment of those loans. In 2006, the lease arrangement was terminated and the lease payable together with the termination amount payable by the Group and the Corporation were settled with the loans to the third party under the agreements for terminating the lease.

28 INTEREST-BEARING BORROWINGS

(a) Interest-bearing borrowings comprise:

	2006		2005	
	Carrying amount $ million	**Fair value $ million**	Carrying amount $ million	Fair value $ million
Capital market instruments				
HK dollar retail notes due 2008 and 2013 – see (c) below	**963**	**1,010**	989	989
US dollar notes due 2010 – see (d) below	**7,779**	**8,323**	7,753	8,522
US dollar notes due 2009 – see (e) below	**7,866**	**8,078**	7,856	8,231
HK dollar notes due 2013 – see (e) below	**808**	**808**	789	789
US dollar notes due 2014 – see (e) below	**389**	**433**	387	444
	17,805	**18,652**	17,774	18,975
Export credit loans – see (f) below	**1,407**	**1,406**	1,700	1,706
	19,212	**20,058**	19,474	20,681

(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 rank equally with all of the Corporation's other unsecured senior indebtedness.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

28 INTEREST-BEARING BORROWINGS *(CONTINUED)*

(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 rank 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 rank equally with all of the Corporation's other unsecured senior indebtedness.

(f) During the year, the Corporation 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 2006, the outstanding balance of the facility amounted to US$153.4 million, of which about 95% bore interest at a fixed rate and the remaining 5% 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$0.1 million has been drawn and US$4.9 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 2006, the outstanding balance of the facility amounted to US$26.8 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 2006, the interest-bearing borrowings were repayable as follows:

	2006 **Capital market instruments** **$ million**	**2006** **Export credit loans** **$ million**	**2006** **Total** **$ million**	2005 Total $ million
Within one year	**–**	**305**	**305**	299
After one year but within two years	**293**	**307**	**600**	304
After two years but within five years	**15,645**	**786**	**16,431**	16,817
After five years	**1,867**	**9**	**1,876**	2,054
	17,805	**1,407**	**19,212**	19,474

29 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 the income statement over the applicable lease terms.

(b) Movements on deferred income comprise:

	Group		Corporation	
	2006	2005	**2006**	2005
	$ million	$ million	**$ million**	$ million
Balance at 1 January	**541**	708	**501**	663
Net amount received and receivable	**445**	76	**445**	76
Provision for amount payable upon termination of a lease arrangement	**–**	(196)	**–**	(196)
Recognised in the income statement	**(459)**	(47)	**(454)**	(42)
Balance at 31 December	**527**	541	**492**	501

(c) Deferred income is expected to be recognised in the income statement as follows:

	Group		Corporation	
	2006	2005	**2006**	2005
	$ million	$ million	**$ million**	$ million
Within one year	**32**	32	**27**	27
After one year	**495**	509	**465**	474
	527	541	**492**	501

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

30 SHARE CAPITAL

	2006 No. of shares	2006 $ million	2005 No. of shares	2005 $ 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

31 RESERVES

The Group

	Development reserve $ million	Investments revaluation reserve $ million	Retained profits $ million	Total $ million
Balance at 1 January 2005	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
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
Balance at 1 January 2006	**–**	**(2)**	**20,535**	**20,533**
Net deficit transferred to income statement on redemption and disposal	**–**	**2**	**–**	**2**
Profit for the year	**–**	**–**	**278**	**278**
Balance at 31 December 2006	**–**	**–**	**20,813**	**20,813**

31 RESERVES *(CONTINUED)*

The Corporation

	Development reserve $ million	Investments revaluation reserve $ million	Retained profits $ million	Total $ million
Balance at 1 January 2005	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
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
Balance at 1 January 2006	**–**	**(2)**	**20,509**	**20,507**
Net deficit transferred to the income statement on redemption and disposal	**–**	**2**	**–**	**2**
Profit for the year	**–**	**–**	**252**	**252**
Balance at 31 December 2006	**–**	**–**	**20,761**	**20,761**

(a) Included in the retained profits of the Group is an amount of $57 million (2005: $30 million) being the retained profits attributable to an associate.

(b) The development reserve represented appropriations of all profits from property developments prior to 2005 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 profits are not available for distribution to the sole shareholder because they are not realised profits of the Corporation. As at 31 December 2006, the amount of reserves available for distribution to the sole shareholder amounted to $20,720 million (2005: $20,384 million).

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

32 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 counterparties 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.

(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, 74% 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 2006, the Corporation had interest rate swaps with a notional contract amount of $800 million (2005: $3,356 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.

32 FINANCIAL ASSETS AND LIABILITIES *(CONTINUED)*

(b) Interest rate risk *(continued)*

(i) Hedging *(continued)*

The net fair value of interest rate swaps entered into by the Corporation at 31 December 2006 was $7 million (2005: $88 million) comprising assets of $7 million (2005: $124 million) and liabilities of nil (2005: $36 million). These amounts are recognised as derivative financial assets.

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 2006.

(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 2006, the Corporation had such interest rate swaps with a notional contract amount of $3,927 million (2005: $1,362 million) and net fair value of $42 million (2005: $40 million) comprising assets of $83 million (2005: nil) and liabilities of $41 million (2005: $40 million).

(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.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

32 FINANCIAL ASSETS AND LIABILITIES *(CONTINUED)*

(b) Interest rate risk *(continued)*

(iii) Effective interest rate and repricing analysis *(continued)*

2006

	Effective interest rate %	Total $ million	One year or less $ million	1-2 years $ million	2-5 years $ million	More than 5 years $ million
Period in which assets/(liabilities) are repriced before maturity						
The Group and the Corporation:						
Loan to non-controlled subsidiary	8.55	4,022	4,022	–	–	–
Interest-bearing borrowings	5.97	(274)	(274)	–	–	–
		3,748	3,748	–	–	–
Period in which assets/(liabilities) are not repriced before maturity						
The Group:						
Cash and cash equivalents	4.74	1,947	1,947	–	–	–
Interest-bearing borrowings	7.30	(18,938)	(200)	(559)	(16,311)	(1,868)
Effect of interest rate swaps	(0.08)	–	4,705	(293)	(2,934)	(1,478)
		(16,991)	6,452	(852)	(19,245)	(3,346)
Period in which assets/(liabilities) are not repriced before maturity						
The Corporation:						
Cash and cash equivalents	4.80	1,795	1,795	–	–	–
Interest-bearing borrowings	7.30	(18,938)	(200)	(559)	(16,311)	(1,868)
Effect of interest rate swaps	(0.08)	–	4,705	(293)	(2,934)	(1,478)
		(17,143)	6,300	(852)	(19,245)	(3,346)

32 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
Period in which assets/(liabilities) 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	–	–	–
Period in which assets/(liabilities) 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)

32 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 only 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 recognised monetary 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 2006 and recognised as derivative financial liabilities was $456 million (2005: $283 million), which was recognised as derivative financial liabilities.

(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 a net derivative financial liability was $41 million (2005: $3 million of net derivative financial assets), which comprises assets of $2 million (2005: $5 million) and liabilities of $43 million (2005: $2 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.

32 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	
	2006 million	2005 million	**2006 million**	2005 million
	Expressed in foreign currency			
US dollars				
Non-derivative financial assets				
– Loans to third party	**–**	88	**–**	–
– Investments	**–**	55	**–**	55
– Interest and other receivables	**1**	6	**1**	4
– Cash and cash equivalents	**178**	292	**178**	292
	179	441	**179**	351
Derivative financial assets				
– Interest rate swaps	**10**	16	**10**	16
– Forward exchange contracts	**–**	1	**–**	1
	10	17	**10**	17
Non-derivative financial liabilities				
– Interest and other payables	**56**	87	**56**	85
– Accrued charges and provisions for capital projects	**1**	5	**1**	5
– Lease payable	**–**	88	**–**	–
– Interest-bearing borrowings	**2,235**	2,274	**2,235**	2,274
	2,292	2,454	**2,292**	2,364
Derivative financial liabilities				
– Interest rate swaps	**5**	5	**5**	5
– Currency swaps	**58**	36	**58**	36
	63	41	**63**	41
Euro				
Non-derivative financial assets				
– Cash and cash equivalents	**2**	1	**2**	1
Japanese yen				
Non-derivative financial assets				
– Cash and cash equivalents	**87**	–	**87**	–
Non-derivative financial liabilities				
– Accrued charges and provisions for capital projects	**916**	–	**916**	–
Derivative financial liabilities				
– Forward exchange contracts	**630**	1	**630**	1
Swiss francs				
Non-derivative financial assets				
– Cash and cash equivalents	**7**	8	**7**	8

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

32 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 adverse market conditions which may 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 2006 and 31 December 2005.

The Group

	2006		2005	
	Carrying amount $ million	Fair value $ million	Carrying amount $ million	Fair value $ million
Non-derivative financial assets				
– Loans to third party	–	–	684	668
– Loan to non-controlled subsidiary	4,022	4,468	3,863	4,105
	4,022	4,468	4,547	4,773
Derivative financial assets				
– Interest rate swaps	90	90	124	124
– Forward exchange contracts	2	2	5	5
	92	92	129	129
Non-derivative financial liabilities				
– Lease payable	–	–	(684)	(668)
– Interest-bearing borrowings	(19,212)	(20,058)	(19,474)	(20,681)
	(19,212)	(20,058)	(20,158)	(21,349)
Derivative financial liabilities				
– Interest rate swaps	(41)	(41)	(76)	(76)
– Currency swaps	(456)	(456)	(283)	(283)
– Forward exchange contracts	(43)	(43)	(2)	(2)
	(540)	(540)	(361)	(361)

32 FINANCIAL ASSETS AND LIABILITIES *(CONTINUED)*

(e) Fair value *(continued)*

The Corporation

	2006 Carrying amount $ million	2006 Fair value $ million	2005 Carrying amount $ million	2005 Fair value $ million
Non-derivative financial assets				
– Loan to non-controlled subsidiary	4,022	4,468	3,863	4,105
Derivative financial assets				
– Interest rate swaps	90	90	124	124
– Forward exchange contracts	2	2	5	5
	92	92	129	129
Non-derivative financial liabilities				
– Interest-bearing borrowings	(19,212)	(20,058)	(19,474)	(20,681)
Derivative financial liabilities				
– Interest rate swaps	(41)	(41)	(76)	(76)
– Currency swaps	(456)	(456)	(283)	(283)
– Forward exchange contracts	(43)	(43)	(2)	(2)
	(540)	(540)	(361)	(361)

(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 32(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 based on 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 based on 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.

(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.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

32 FINANCIAL ASSETS AND LIABILITIES *(CONTINUED)*

(f) Estimation of fair value *(continued)*

(iv) Loans to third party and lease payable

The fair value was estimated based on 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:

	2006	2005
Interest rate swaps, currency swaps	**3.99% – 5.54%**	4.22% – 5.43%
Loan to non-controlled subsidiary and interest-bearing borrowings	**3.69% – 6.39%**	4.05% – 5.82%
Loans to third party and lease payable	**–**	7.43% – 7.83%

33 NOTES TO THE CONSOLIDATED CASH FLOW STATEMENT

Reconciliation of operating profit after depreciation and amortisation to net cash inflow from operations

	2006 $ million	2005 $ million
Operating profit after depreciation and amortisation	**292**	98
Depreciation and amortisation	**2,288**	2,258
Fixed assets written off	**24**	43
Increase in stores and spares	**(19)**	(24)
Decrease in other receivables	**210**	194
Decrease in other payables and deferred income	**(131)**	(177)
Decrease in loans to third party	**–**	16
Net cash inflow from operations	**2,664**	2,408

34 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), 5, 13(j), 14(c), (d) and (e), 15(b) and (c), 16, 17, 20, 23 and 26 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 5 to the financial statements.

34 RELATED PARTIES *(CONTINUED)*

Major related party transactions entered into by the Group in prior years which are still relevant for the current year comprise:

(i) On 15 September 1998, the Government approved the construction of West Rail, Phase I to be undertaken by the Corporation. The West Rail Project Agreement, which set out how the project was to be undertaken and the respective obligations of the Government and the Corporation in terms of the financing, design, construction and operation of West Rail, Phase I, was signed on 23 October 1998. On 24 February 2000, the Corporation and the Government entered into a shareholding agreement for undertaking all property developments along the West Rail, Phase I route (note 20).

(ii) The Corporation entered into a project agreement for the East Rail Extensions with the Government in 28 February 2003. The project agreement provided for the financing, design, construction and operations of the East Rail Extensions and related services and facilities.

(iii) The Corporation entered into a project agreement for the financing, design, construction and operation of Kowloon Southern Link with the Government on 6 October 2005. Under the terms of the KSL Project Agreement, the Corporation will be responsible for, and will finance the entire capital cost of constructing the Kowloon Southern Link, along with the costs of the removal, replacement, modification or improvement of existing facilities affected by or required as a consequence of the construction of the Kowloon Southern Link.

(iv) The Corporation accepted an offer from the Government to allow the Corporation to proceed with the development of the site at Ho Tung Lau and Wu Kai Sha in March 2003 and October 2005 respectively.

During the year, the Group entered into the following material related party transactions:

(i) The Corporation accepted an offer from the Government to allow the Corporation to proceed with the development of the site at Tai Wai Maintenance Centre in July 2006.

(ii) In the construction of the new railway projects, certain essential project works are embedded within the infrastructure works to be undertaken by the Government or its related parties. The Government and its related parties have entered into entrustment agreements and certain services agreements with the Corporation under which the Corporation has agreed to carry out works on behalf of the Government and provide operational services such as maintenance and building management services. The works done and services provided by the Corporation are reimbursable and the details of amounts payable and receivable as at 31 December 2006 are provided in notes 14 and 23 respectively.

(iii) Octopus Cards Limited earned fees for the use of the Octopus cards system from the Corporation and paid ticket loading agent fees, handling fees and interest to the Corporation. Details of the transactions are disclosed in note 18 to the financial statements.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

35 OUTSTANDING COMMITMENTS

(a) Commitments outstanding in respect of capital expenditure not provided for in the financial statements were as follows:

	2006 $ million	2005 $ million
Investment properties		
– authorised and contracted for	**2**	41
– authorised but not contracted for	**2**	7
Property, plant and equipment		
– authorised and contracted for	**3,860**	4,093
– authorised but not contracted for	**3,784**	3,778
Interest in leasehold land held for own use		
– authorised and contracted for	**219**	291
– authorised but not contracted for	**38**	30
Balance at 31 December	**7,905**	8,240

(b) The total future minimum lease payments under non-cancellable operating leases for property with varying terms and renewal rights are payable as follows:

	2006 $ million	2005 $ million
Within one year	**38**	46
After one year but within five years	**49**	94
Balance at 31 December	**87**	140

The operating leases are mainly related to work areas used for construction of new railways. During the year, amounts payable under operating leases totalling $46 million (2005: $22 million) were capitalised as part of construction in progress or deferred expenditure, as appropriate.

36 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.

36 RETIREMENT BENEFIT SCHEME *(CONTINUED)*

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.

37 DEBT FACILITIES AND PROGRAMMES

(a) Total unutilised debt facilities and programmes available to the Corporation comprise:

	2006 $ million	2005 $ million
$2,200 million (2005: $2,200 million) short-term uncommitted revolving credit facilities	**2,200**	2,200
$20 million (2005: $20 million) letters of credit	**20**	20
$25 million (2005: $25 million) overdraft facilities	**25**	25
$8,000 million (2005: $8,000 million) syndicated loan facilities	**8,000**	8,000
US$3,000 million (2005: US$3,000 million) medium term note programme	**14,418**	14,377
US$292 million (2005: US$292 million) letters of credit for leveraged leases	**2,279**	2,273
US$182 million (2005: US$220 million) export credit loan facilities	**10**	11
	26,952	26,906

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

37 DEBT FACILITIES AND PROGRAMMES *(CONTINUED)*

(b) The unutilised debt facilities are expected to expire as follows:

	2006 $ million	2005 $ million
Floating rate		
– expiring within one year	2,620	2,245
– expiring after one year	9,914	10,284
Fixed/floating rate to be determined when issued		
– expiring after one year	14,418	14,377
	26,952	26,906

38 CONTINGENT LIABILITIES

At 31 December 2006, the Group had contingent liabilities arising from the land resumption claims and certain contractors' claims in respect of the construction of the Kowloon Southern Link, 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 2006 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 2006. The Group is in the process of resolving these claims.

39 IMPAIRMENT OF ASSETS

At 31 December 2006, 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 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 2006.

The cash flows of the railway network were estimated on the basis that no Rail Merger with MTRCL will occur as HKAS 36 requires that the cash flows shall exclude those cash flows arising from future uncommitted restructurings. The status of the proposed Rail Merger with MTRCL is described in note 40.

As a result of this assessment, management considers that the railway assets of the Group are not impaired at 31 December 2006 and, accordingly, that no provision for impairment of the Group's railway assets is required at that date.

40 PROPOSED MERGER OF THE CORPORATION AND MTRCL

On 11 April 2006, the Secretary for the Environment, Transport and Works and the Secretary for Financial Services and the Treasury, each for and on behalf of the Government, signed a Non-binding memorandum of understanding (the "MOU") with MTRCL, providing for a proposed long term service concession of the Corporation's rail operations and the sale of certain rail and property interests. These arrangements have been commonly described publicly as a merger and are referred to herein as the "Rail Merger"; however, these arrangements do not involve a legal merger of MTRCL and the Corporation. The proposed terms for the implementation of the Rail Merger have been set out in the Rail Merger Bill tabled for consideration by the Legislative Council of Hong Kong ("LegCo"). The Rail Merger Bill was published in the Government Gazette on 30 June 2006 and was introduced to the LegCo on 5 July 2006. Under the proposed terms of the Rail Merger, the Corporation would retain legal ownership of substantially all of the rail system and would grant to MTRCL the right to manage the Corporation's existing railway lines and other rail-related businesses through a service concession for a period of 50 years (the "Service Concession Period").

MTRCL would keep all revenues generated from the operation of the Corporation's railway network and other rail-related businesses and would make an upfront payment to the Corporation of $4.25 billion and an annual fixed rental payment of $750 million, as well as a variable annual payment based on revenue generated from the railway and other rail-related businesses during each financial year. In addition, MTRCL would pay $7.79 billion to buy property interests from the Corporation comprising property development rights of eight sites along the East Rail, the Ma On Shan Rail, the Light Rail and the Kowloon Southern Link, certain investment properties related to the East Rail and the Light Rail currently held by the Corporation and the Corporation's rights to manage certain properties.

The Rail Merger Bill contemplates that during the Service Concession Period, the Corporation would generally remain as the borrower or obligor in relation to its existing financial obligations and contingent liabilities; however, whether any additional party assumes liability for any existing financial obligations will depend on the final terms and conditions of the Rail Merger.

The Rail Merger is subject to, among other things: (i) the enactment of the Rail Merger Bill by the LegCo to implement the Rail Merger; (ii) the negotiation and execution of definitive transaction documents and the satisfaction of any conditions set forth therein; and (iii) the approval of the minority shareholders of MTRCL. All parties remain in discussions in respect of definitive documentation for the Rail Merger. Accordingly, there can be no assurance that the Rail Merger will be implemented on the terms proposed in the MOU or that the Rail Merger or any other transaction will occur at all. Timing for completion of the Rail Merger, if it occurs, remains uncertain and could be subject to delays. The financial impacts of the Rail Merger on the financial statements are also uncertain at this stage and cannot be reliably estimated prior to the finalisation of the definitive transaction documents. Accordingly, the financial statements have not taken into account the potential impact of the proposed merger.

41 COMPARATIVE FIGURES

Certain comparative figures of "amortisation of interest of leasehold land held for own use under operating leases" have been re-classified from "operating costs before depreciation and amortisation" to "depreciation and amortisation" (see note 6) in conformity with the current year's presentation, which is considered to better reflect the nature of the expenses.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

42 ACCOUNTING ESTIMATES AND JUDGEMENTS

(a) Key sources of estimation uncertainty

Note 32 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), 26 and 38), determination of the recoverability of deferred tax assets (see note 9(d)), the valuation of investment properties (see note 13(f)), assessment of the possibility of implementation of Shatin to Central Link project (see note 15(a)) and assessment of the outstanding risk and obligations in recognition of profit from property development (see note 29).

(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 32) and impairment of assets (see note 39).

43 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE ANNUAL ACCOUNTING YEAR ENDED 31 DECEMBER 2006

Up to the date of issue of these financial statements, the HKICPA has issued a number of amendments, new standards and interpretations which are not yet effective for the year ended 31 December 2006 and which have not been adopted in these financial statements.

The Group is in the process of making an assessment of what the impact of these amendments, new standards and new interpretations is expected to be in the period of initial application. So far it has concluded that the adoption of them is unlikely to have a significant impact on the Group's and the Corporation's results of operations and financial position.

In addition, the following developments may result in new or amended disclosures in the financial statements:

	Effective for accounting periods beginning on or after
Amendment to HKAS 1, Presentation of financial statements: capital disclosures	1 January 2007
HKFRS 7, Financial instruments: disclosures	1 January 2007

CONSOLIDATED INCOME STATEMENT

for the year ended 31 December 2006 (Expressed in foreign currencies)

	Note	2006 US$ million	2006 GBP million	2006 JPY million
Turnover	3	721	367	84,976
Operating costs before depreciation and amortisation	4	(390)	(199)	(45,979)
Operating profit before depreciation and amortisation	5	331	168	38,997
Depreciation and amortisation	6	(294)	(149)	(34,583)
Operating profit after depreciation and amortisation		37	19	4,414
Interest and finance income	7(a)	64	32	7,542
Interest and finance expenses	7(b)	(104)	(53)	(12,319)
Profit from property development		55	28	6,454
Share of profit of associate		3	2	408
Profit before unrealised gains/losses		55	28	6,499
Losses on changes in fair value of derivative financial instruments and hedged borrowings	8	(26)	(13)	(2,993)
Net valuation gains on investment properties	13	13	7	1,497
Profit before taxation		42	22	5,003
Income tax	9(a)	(6)	(4)	(801)
Profit for the year wholly attributable to the sole shareholder of the Corporation	10	36	18	4,202
Dividend payable to the sole shareholder of the Corporation attributable to the year proposed after the balance sheet date	11(a)	11	5	1,239

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$15.335 and JPY1=HK$0.06616

CONSOLIDATED BALANCE SHEET

at 31 December 2006 (Expressed in foreign currencies)

	Note	2006 US$ million	2006 GBP million	2006 JPY million
Assets				
Fixed assets	13			
– Property, plant and equipment		7,499	3,815	884,190
– Investment properties		177	90	20,828
		7,676	3,905	905,018
Interest in leasehold land held for own use under operating leases	13	708	360	83,494
Construction in progress	14	1,749	890	206,227
Deferred expenditure	15	178	91	20,995
Properties under development	16	58	29	6,787
Interest in associate	18	13	6	1,496
Loan to non-controlled subsidiary	20	516	262	60,792
Derivative financial assets	32(e)	12	6	1,391
Stores and spares	22	46	24	5,472
Interest and other receivables	23	73	37	8,630
Cash and cash equivalents	24	250	127	29,429
		11,279	5,737	1,329,731
Liabilities				
Interest and other payables	25	315	160	37,167
Accrued charges and provisions for capital projects	26	263	134	31,046
Derivative financial liabilities	32(e)	69	35	8,162
Interest-bearing borrowings	28	2,463	1,253	290,387
Deferred income	29	68	35	7,966
Deferred tax liabilities	9(d)	417	212	49,123
		3,595	1,829	423,851
Net Assets		7,684	3,908	905,880
Capital and Reserves				
Share capital	30	5,015	2,551	591,294
Reserves	31	2,669	1,357	314,586
Total equity		7,684	3,908	905,880

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$15.335 and JPY1=HK$0.06616

CORPORATION BALANCE SHEET

at 31 December 2006 (Expressed in foreign currencies)

	Note	2006 US$ million	2006 GBP million	2006 JPY million
Assets				
Fixed assets	13			
– Property, plant and equipment		7,495	3,812	883,646
– Investment properties		177	90	20,828
		7,672	3,902	904,474
Interest in leasehold land held for own use under operating leases	13	708	360	83,494
Construction in progress	14	1,749	890	206,227
Deferred expenditure	15	178	91	20,995
Properties under development	16	58	29	6,787
Interest in associate	18	5	3	635
Loan to non-controlled subsidiary	20	516	262	60,792
Derivative financial assets	32(e)	12	6	1,391
Stores and spares	22	46	24	5,472
Interest and other receivables	23	74	37	8,736
Cash and cash equivalents	24	230	117	27,131
		11,248	5,721	1,326,134
Liabilities				
Interest and other payables	25	296	150	34,870
Accrued charges and provisions for capital projects	26	263	134	31,046
Derivative financial liabilities	32(e)	69	35	8,162
Interest-bearing borrowings	28	2,463	1,253	290,387
Deferred income	29	63	32	7,437
Deferred tax liabilities	9(d)	417	212	49,138
		3,571	1,816	421,040
Net Assets		7,677	3,905	905,094
Capital and Reserves				
Share capital	30	5,015	2,551	591,294
Reserves	31	2,662	1,354	313,800
Total equity		7,677	3,905	905,094

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$15.335 and JPY1=HK$0.06616

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December 2006 (Expressed in foreign currencies)

	Note	2006 US$ million	2006 GBP million	2006 JPY million
Total equity at 1 January		7,648	3,890	901,648
Net profit for the year	31	36	18	4,202
Revaluation deficit transferred to the income statement on redemption and disposal of available-for-sale securities	31	–	–	30
Total equity at 31 December		7,684	3,908	905,880

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$15.335 and JPY1=HK$0.06616

CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December 2006 (Expressed in foreign currencies)

	Note	2006 US$ million	2006 GBP million	2006 JPY million
Operating activities				
Net cash inflow from operations	33	341	174	40,266
Net cash inflow from property development		193	98	22,748
Hong Kong profits tax paid		–	–	(15)
Net cash inflow from operating activities		534	272	62,999
Investing activities				
Decrease in deposits with banks with maturity more than three months when placed		139	71	16,385
Payments for capital expenditure:				
– East Rail Extensions project		(261)	(133)	(30,804)
– Kowloon Southern Link project		(173)	(87)	(20,315)
– other capital projects and purchase of fixed assets		(146)	(74)	(17,231)
Interest received		30	15	3,582
Repayment from non-controlled subsidiary		5	2	574
Receipts on sales of fixed assets		1	–	76
Receipts on redemption and disposal of available-for-sale securities		53	27	6,212
Net cash outflow from investing activities		(352)	(179)	(41,521)
Net cash inflow before financing		182	93	21,478
Financing activities				
Net cash outflow on repayment of loans		(38)	(20)	(4,504)
Interest paid		(178)	(91)	(20,980)
Net cash outflow relating to derivative financial instruments		(10)	(5)	(1,164)
Finance expenses paid		(3)	(1)	(317)
Net cash outflow from financing activities		(229)	(117)	(26,965)
Net decrease in cash and cash equivalents		(47)	(24)	(5,487)
Cash and cash equivalents at 1 January		236	120	27,796
Cash and cash equivalents at 31 December		189	96	22,309
Analysis of the balances of cash and cash equivalents				
Cash at bank and in hand	24	9	4	1,073
Deposits with banks with maturity of less than three months when placed	24	180	92	21,236
		189	96	22,309

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$15.335 and JPY1=HK$0.06616

TEN-YEAR STATISTICS

FINANCIAL (HK$ million)	**2006**	2005	2004	2003
Income Statement				
Revenue from operations	**5,622**	5,383	4,976	4,426
Transport	**4,746**	4,612	4,281	3,819
Property	**876**	771	695	607
Operating profit before depreciation and amortisation	**2,580**	2,356	2,172	2,297
Net interest and finance (income)/expenses	**316**	298	41	(353)
Profit from property development	**427**	–	–	–
Profit/(loss) before unrealised gains/losses	**430**	(185)	465	1,909
Net profit/(loss)				
Before property development and related profits tax	**(74)**	317	513	1,381
After property development	**278**	317	513	1,381
Dividend	**82**	–	172	620
Balance Sheet				
Fixed assets (including interest in leasehold land held for own use under operating leases)	**65,400**	66,943	67,746	51,857
Construction in progress	**13,644**	10,411	6,991	15,101
Deferred expenditure	**1,389**	1,210	1,462	900
Properties under development	**449**	1,537	1,892	1,448
Loan to non-controlled subsidiary	**4,022**	3,863	3,576	3,232
Investments	**–**	449	4,323	12,244
Cash and cash equivalents	**1,947**	3,394	3,531	2,677
Other assets	**1,124**	1,945	1,865	1,745
Total assets	**87,975**	89,752	91,386	89,204
Interest-bearing borrowings	**19,212**	19,474	19,748	20,013
Deferred tax liabilities	**3,250**	3,198	3,251	3,131
Other liabilities	**5,580**	7,427	8,325	5,855
Total liabilities	**28,042**	30,099	31,324	28,999
Equity	**59,933**	59,653	60,062	60,205
Key financial data				
Capital expenditure	**3,317**	3,835	9,025	11,122
Return on equity (%)	**–**	1	1	2
Revenue per employee excluding project staff	**1.058**	1.050	0.994	0.950
Debt/equity ratio	**1:3.1**	1:3.1	1:3.0	1:3.0
Debt to total capitalisation (%)	**24**	25	25	25
Interest cover (times)	**2.2**	1.9	1.8	2.9

2002	2001	2000	1999	1998	1997
4,830	4,797	4,731	4,426	4,137	3,718
4,213	4,139	4,089	3,817	3,554	3,245
617	658	642	609	583	473
2,659	2,572	2,571	2,249	2,032	1,769
(618)	(490)	(302)	(222)	(164)	(20)
94	24	87	71	88	2,308
2,662	2,436	2,289	1,844	1,717	3,640
2,116	2,411	2,201	1,832	1,565	1,325
2,210	2,435	2,288	1,903	1,639	3,263
620	–	–	–	–	–
14,051	13,745	13,236	13,301	12,336	9,205
42,298	26,939	17,400	9,451	3,836	3,399
156	4,216	1,104	326	234	2,224
1,153	739	91	87	482	453
2,048	1,316	602	114	44	–
19,165	27,752	27,789	22,270	5,027	–
5,528	6,473	8,597	11,589	9,510	297
1,709	1,357	1,600	1,153	476	288
86,108	82,537	70,419	58,291	31,945	15,866
17,753	16,831	16,395	8,299	–	–
2,604	–	–	–	–	–
6,239	6,126	5,123	3,404	1,692	1,549
26,596	22,957	21,518	11,703	1,692	1,549
59,512	59,580	48,901	46,588	30,253	14,317
12,308	14,595	10,829	8,444	3,286	3,582
4	4	5	4	5	23
1.222	1.240	1.248	1.183	1.127	1.053
1:3.4	1:3.5	1:3.0	1:5.6	–	–
23	22	25	15	–	–
3.4	3.3	3.4	7.9	–	–

TEN-YEAR STATISTICS

OPERATING (million)	**2006**	2005	2004	2003
East Rail including Tsim Sha Tsui Extension and Ma On Shan Rail*				
Electric Multiple Unit Operations:				
Total number of passengers	**335**	325	292	278
Domestic	**247**	239	207	196
Cross-boundary	**88**	86	85	82
Daily average number of passengers	**0.918**	0.892	0.799	0.762
Revenue car-km operated	**92.00**	91.56	79.35	78.68
Total passenger-km travelled	**4,824**	4,731	4,385	4,183
Safety performance (unit)				
Number of passengers & public injured	**270**	247	216	181
Passengers & public injured per million passengers carried	**0.74**	0.71	0.74	0.65
Through Train Operations:				
Total number of passengers	**3.3**	3.1	3.0	2.1
Light Rail				
Total number of passengers	**136**	136	132	106
Daily average number of passengers	**0.374**	0.373	0.360	0.291
Revenue car-km operated	**10.04**	11.09	11.29	10.71
Safety performance (unit)				
Number of passengers & public injured	**40**	23	18	27
Passengers & public injured per million passengers carried	**0.29**	0.17	0.14	0.25
West Rail**				
Total number of passengers	**73**	65	48	1
Daily average number of passengers	**0.200**	0.179	0.131	0.107
Revenue car-km operated	**30.87**	32.55	34.17	1.15
Safety performance (unit)				
Number of passengers & public injured	**37**	36	38	3
Passengers & public injured per million passengers carried	**0.51**	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.*

2002	2001	2000	1999	1998	1997
296	292	288	275	269	261
204	205	204	200	204	206
92	87	84	75	65	55
0.812	0.799	0.788	0.755	0.737	0.716
78.92	75.57	73.78	72.58	71.40	69.33
4,540	4,487	4,466	4,263	4,204	4,115
180	191	192	186	168	157
0.61	0.65	0.67	0.67	0.62	0.60
2.3	2.1	2.0	1.7	1.4	1.5
114	117	118	115	114	126
0.314	0.319	0.323	0.314	0.314	0.346
10.76	10.68	10.68	10.25	10.29	9.66
33	35	27	51	42	73
0.29	0.30	0.23	0.44	0.37	0.58
–	–	–	–	–	–
–	–	–	–	–	–
–	–	–	–	–	–
–	–	–	–	–	–
–	–	–	–	–	–

TEN-YEAR STATISTICS

OPERATING (million)	**2006**	2005	2004	2003
Bus				
Total number of passengers*	**30**	27	20	26
Bus-km operated*	**7.31**	6.29	6.95	7.70
Safety performance (unit)				
Number of passengers & public injured	**7**	8	8	4
Passengers & public injured per million passengers carried	**0.15**	0.18	0.21	0.1
Freight				
Freight volume				
Southbound goods (tonnage)	**0.4**	0.4	0.5	0.6
Northbound goods (tonnage)	**0.2**	0.2	0.3	0.4
Livestock (head)	**—**	0.1	0.4	0.7
Employees at year end (number)				
Transport	**4,524**	4,372	4,227	3,914
Property	**131**	111	109	97
Capital Projects	**733**	754	867	1,211
Corporate & other services	**661**	642	671	649
	6,049	5,879	5,874	5,871

* *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.*

	2002	2001	2000	1999	1998	1997
	26	21	16	16	38	39
	6.78	6.20	5.43	5.17	6.03	5.84
	4	8	6	4	14	23
	0.09	0.21	0.18	0.12	0.37	0.59
	0.7	0.6	0.7	0.7	0.7	0.9
	0.5	0.4	0.4	0.5	0.5	0.6
	0.9	0.9	1.1	1.2	1.3	1.4
	3,228	3,218	3,202	3,179	3,169	3,121
	92	75	74	68	61	39
	1,557	1,303	1,077	841	518	201
	633	574	514	494	442	370
	5,510	5,170	4,867	4,582	4,190	3,731

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.
Agricultural Bank of China
American Express Bank Limited
Australia and New Zealand Banking Group Limited
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
China Construction Bank Corporation
Chong Hing Bank Limited*
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
Hang Seng Bank Limited
HSBC
HSH Nordbank AG
Industrial and Commercial Bank of China (Asia) Limited
ING Bank N.V.
Intesa Sanpaolo S.p.A.**
Japan Bank for International Cooperation
JPMorgan Chase Bank, National Association
KBC Bank N.V.
Lehman Brothers
Malayan Banking Berhad
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
Shanghai Commercial Bank Limited
Societe Generale
Standard Chartered Bank (Hong Kong) Limited
Sumitomo Mitsui Banking Corporation
Svenska Handelsbanken AB (publ)
Tai Fung Bank Limited
UBS AG
United Overseas Bank Limited
WestLB AG
Wing Hang Bank Limited
Wing Lung Bank Limited

* *Effective 23 December 2006, the name of Liu Chong Hing Bank Limited was changed to Chong Hing Bank Limited.*
** *Following the merger of Banca Intesa S.p.A and Sanpaolo IMI S.p.A on 1 January 2007, the merged bank was named Intesa Sanpaolo S.p.A.*

LIST OF CONSULTANTS

Name of Contract	Contract No.	Consultant	Division	Contract Amount (Lump Sum) (in HK$)
1. Combined NOL/ERL Preliminary Project Feasibility Study	NOL/ERL-200	Ove Arup & Partners Hong Kong Ltd.	Capital Projects	$12,700,000.00
2. Combined NOL/ERL Project Business Study	NOL/ERL-100	McKinsey & Co. Inc. Hong Kong	Capital Projects	$9,500,000.00
3. TBM Specialists Consultancy Services for KDB200	KGS837	Maunsell Consultants Asia Ltd.	Capital Projects	$7,000,000.00
4. Consultancy Services for Addition and Alteration Works at Hung Hom and East Tsim Sha Tsui	KGS838	Maunsell Consultants Asia Ltd.	Capital Projects	$3,880,000.00
5. Independent Safety Assessor for KSL Signalling Systems	KGS819	Atkins China Ltd.	Capital Projects	$3,495,000.00
6. Consultancy Study on Effect of Soft Track Form on EMU Performances	KGS839	Interfleet Technology Ltd.	Capital Projects	$2,737,371.00
7. Preliminary Environmental Assessment, Ecological Survey and Impact Assessment, and Environmental Impact Assessment	NOL/ERL-300	Maunsell Environmental Management Consultants Ltd.	Capital Projects	$2,280,000.00
8. Combined NOL/ERL Ground Investigation Works Site Supervision Consultancy	NOL/ERL-400	Scott Wilson Ltd.	Capital Projects	$1,439,275.00
9. Overseas Inspection of EMU	KGS816	Parsons Brinckerhoff (Asia) Ltd.	Transport	$1,266,600.00
10. Moving Walkways in Middle Road Subway	KDC102	Ove Arup & Partners Hong Kong Ltd.	Capital Projects	$700,000.00

GLOSSARY OF FINANCIAL TERMS AND FURTHER INFORMATION

Glossary of Financial Terms

Operating margin (before depreciation and amortisation)
Operating profit before depreciation and amortisation divided by turnover.

Operating margin (after depreciation and amortisation)
Operating profit after depreciation and amortisation 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 depreciation and amortisation plus profit from property development, 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:

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Design and production: Yellow Creative (HK) Limited www.yellowcreative.com Principal photography: Graham Uden

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This annual report is printed on environmentally-friendly, totally chlorine-free paper