# BUSINESS REVIEW

The year 2006 was a major milestone in the Group's history. During the year, HKCG entered into an agreement with the Company pursuant to which the Company acquired equity interests in 10 PRC piped gas companies and took assignment of their shareholder loans from HKCG while HKCG became the single largest shareholder of the Company. At the same time, the Group also made favourable progress in its business development.

## REVIEW OF OPERATIONS

For the year ended 31 December 2006, the Group recorded a turnover of approximately HK$2,642.9 million, an increase of 13.7% over the previous year. Gross profit decreased by 41.3% to approximately HK$404.7 million. The Group recorded earnings before interests, taxation, depreciation and amortisation (EBITDA) of approximately HK$181.7 million and a loss attributable to equity holders of the Company of approximately HK$256.3 million, a significant decrease from HK$155.8 million profit recorded last year.

The decrease in gross profit was mainly due to fewer number of new piped gas user connections recorded during the year when compared to last year, and the lower average connection fee income per connection for our projects in the northeastern part of the PRC when compared to the Sichuan area.

The loss attributable to equity holders of the parent is mainly attributed from the loss in fair value on the two interest rate swaps of approximately HK$124.2 million; increase in the interest expenses of approximately HK$61.3 million; increase in the distribution, and selling and administrative expenses of approximately HK$172.5 million; and a fewer number of new piped gas user connections recorded during the period when compared to the same period last year. However, the loss was slightly offset by the discount on acquisition of subsidiaries and additional interests of a subsidiary of approximately HK$28.6 million.

## LOSS IN THE FAIR VALUE ON THE TWO INTEREST RATE SWAPS

The loss in fair value of the two interest rate swaps during the year amounted to approximately HK$124.2 million (approximately US$15.9 million). On 21 and 22 September 2006, both swaps were terminated at an aggregate value of US$55.95 million (approximately HK$433.6 million).

## INTEREST EXPENSES

In 2005, the interest rate swaps generated a net savings of approximately HK$44.0 million, however in 2006 the interest rate swaps generated a net outflow of approximately HK$12.9 million contributing to an increase in interest expense of approximately HK$61.3 million during the year.

## DISTRIBUTION AND SELLING AND ADMINISTRATIVE EXPENSES

Distribution and selling and administrative expenses increased significantly to approximately HK$394.8 million, an increase of approximately 77.6% when compared to last year, of which total staff costs and depreciation charges increased by approximately HK$72.1 million and HK$41.3 million respectively. The increase was mainly attributable to the newly acquired and established operating subsidiaries and the increase in the allowance for doubtful debts during the year. Although the new operating subsidiaries contributed in terms of turnover and gross profit, these operating subsidiaries are currently being transformed from a state owned enterprise ("SOE") to a Panva Gas company, it is expected that the Group will not immediately enjoy the benefits of the efficiency and effectiveness of such transformation measures.

The eight new subsidiaries completed during the year contributed approximately HK$80.8 million to the increase in the distribution and selling and administrative expenses.

Allowance for doubtful debts of HK$40 million were charged to the profit and loss during the year. The increase in such a provision represents a more prudent approach adopted by the Group on the outstanding receivables such as deposits paid to suppliers.

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## SALE OF PIPED GAS

Sale of piped gas business comprises the direct sale of piped natural gas, piped LPG and piped coal gas to end-user households. Turnover of the business increased by 144.5% to approximately HK$374.3 million, accounting for approximately 14.2% of the Group's aggregate turnover derived from the gas fuel businesses in 2006. The rapid growth of the piped gas business underlines the Group's shift towards a utility business model with the sale of piped gas becoming a significant source of income.

As at 31 December 2006, the Group had approximately 1,333,600 households customers for its sale of piped gas, an increase of approximately 581,000 households over 2005.

## GAS PIPELINE CONSTRUCTION

The Group's gas pipeline construction business mainly includes the development and maintenance of piped gas stations and networks through which the Group provides direct connection of piped gas to end-user households and receives a connection fee. For the year ended 31 December 2006, the Group recorded a turnover of approximately HK$331.2 million from connection fee, which accounted for approximately 12.5% of the Group's total turnover during the year, representing a drop of approximately 53.5% when compared to the previous year.


The total number of domestic customers as at 31 December 2006 totalled about 1,333,600 households, an increase of approximately 581,000 households over 2005, of which about 466,100 households were existing customers of the newly acquired subsidiaries and about 114,900 households were new customers during the period. The number of new connections made by the Group during the year decreased by approximately 42.0% when compared with the previous year's 198,000 domestic customers.

The decrease in connection fee income was caused by various factors, including the lower connection fee per connection from our projects in the northeastern part of the PRC than the Sichuan area; the high penetration of urban city centers in some early acquired projects; the slowdown in local property development as a result of the latest wave of austerity measures; and the ongoing transformation of a number of SOEs projects acquired in late 2005. The transformation included the implementation of a new marketing strategy requiring the new companies to actively get new connections instead of passively waiting for customers to knock our doors.

## SALE OF LPG

Sale of LPG business comprises the sale of LPG in bulk to wholesale customers and the retail of LPG to end-user households and industrial and commercial customers. Despite the higher costs of LPG during 2006, the Group's LPG business maintained a solid growth. For the year ended 31 December 2006, turnover derived from the sale of LPG in bulk amounted to approximately HK$1,110.8 million, accounting for approximately 42.0% of the Group's total turnover, an increase of approximately 30.0% when compared to last year. The retail business turnover increased by approximately 37.5% to HK$790.0 million, accounting for approximately 29.9% of the Group's total turnover.

As at 31 December 2006, the Group had approximately 2,570,000 domestic customers covering approximately 10 million people for its retail sale of LPG in cylinders, an increase of approximately 270,000 households over 31 December 2005.

## ACQUISITION OF NEW PROJECTS


Moreover, the Group leveraged its competitive advantages and acquired the Fuxin piped gas project in Liaoning, further strengthening the Group's strategic position in the northeastern PRC region. Furthermore, the Group's acquisition of a LPG project in Hangzhou enhanced its control and leading edge in this market.

On 4 December 2006, HKCG and the Company announced that the Company agreed to acquire the entire issued share capital of each of the eight companies held by Hong Kong & China Gas (China) Limited ("HK&CG (China)") (collectively the "Target Companies"), which hold equity interests in 10 PRC companies that are engaged in piped gas businesses. The Company also agreed that it will take assignment of the outstanding loans due from the Target Companies to HK&CG (China) or its associates, being approximately HK$568.1 million, together with all interest accrued thereon, if any. In consideration of the acquisition (which includes taking assignment of the shareholder loans), the Company agreed to issue approximately 773 million new shares to HK&CG (China), 43.97% of the enlarged issued share capital of the Company. The resolutions related to the agreement were approved at the extraordinary general meeting of the Company and the completion of the agreement took place on 1 March 2007, upon which HK&CG (China) became the single largest shareholder of the Company. The Target Companies are private companies incorporated in the British Virgin Islands ("BVI") and are wholly-owned subsidiaries of HK&CG (China). They are namely: Hong Kong & China Gas (Yantai) Limited, Hong Kong & China Gas (Qingdao) Limited, Hong Kong & China Gas (Anqing) Limited, Hong Kong & China Gas (Taian) Limited, Hong Kong & China Gas (Maanshan) Limited, Hong Kong & China

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Gas (Weihai) Limited, Hong Kong & China Gas (Weifang) Limited, and Hong Kong & China Gas (Zibo) Limited. These eight companies hold equity interests in the following 10 PRC companies, which are either wholly-owned foreign enterprises or sino-foreign joint ventures:

| Name of the PRC Company | Address | Scope of Operations | Foreign Equity Holder | Interest Held by Foreign Equity Holder | Registered Capital |
|---|---|---|---|---|---|
| Longkou Hong Kong and China Gas Company Limited | 8th Floor, Jiu Ding Building, Wang Cheng, Longkou, Shandong province | The construction and operation of city gas facilities, the production, processing, transportation, and selling of piped gas (non coal gas) (no engagement in the production and operation of dangerous chemicals without prior approval and the required licenses), the production and selling of kitchenware and related equipment, and the provision of related services in Longkou | Hong Kong & China Gas (Yantai) Limited | 100% | RMB42.0 million |
| Qingdao Zhongji Hong Kong and China Gas Company Limited | North end, Chengxisilu, Jimo, Qingdao | The investing, construction and operation of city gas facilities including piped gas networks and related facilities, the production, processing, transportation, and selling of piped gas (including substitute for natural gas, LPG and such natural gas to be introduced in the future), the production and selling of kitchenware and related equipment, the provision of after sales services, and the engagement in other related businesses in Jimo | Hong Kong & China Gas (Qingdao) Limited | 90% | RMB18.5 million |

| Name of the PRC Company | Address | Scope of Operations | Foreign Equity Holder | Interest Held by Foreign Equity Holder | Registered Capital |
|---|---|---|---|---|---|
| Anqing Hong Kong and China Gas Company Limited | 294 Yenminlu, Anqing | The investing, construction and operation of piped gas facilities, the production, processing, transportation, and selling of piped gas (including cylindered gas), the wholesale and retail of LPG, condensed natural gas, the operation of automobile gas filling stations, the production and selling of kitchenware, meters and related equipment, the provision of design, installation, maintenance and repair services for gas facilities, and the engagement in other related businesses in Anqing | Hong Kong & China Gas (Anqing) Limited | 50% | RMB73.0 million |
| Qingdao Dong Yi Hong Kong and China Gas Company Limited | 197 Xianggangdonglu, Qingdao High and New Technology Development Park | The investing, construction and operation of piped gas facilities, management networks and other ancillary facilities, and the production of kitchenware in Qingdao High and New Technology Development Park | Hong Kong & China Gas (Qingdao) Limited | 60% | RMB30.0 million |
| Taian Taishan Hong Kong and China Gas Company Limited | 50 Longtanlu, Taian | The construction of piped gas networks, the storage, processing and supply of city piped gas and cylindered gas, the installation and maintenance of gas equipment and ancillary equipment | Hong Kong & China Gas (Taian) Limited | 50% | RMB80.0 million |
| Maanshan Hong Kong and China Gas Company Limited | 30 Hudongchonglu, Maanshan | The production, transportation, and selling of piped gas, the provision of services (including customer service), the construction and operation of city gas projects (including piped gas networks), the design and operation of city gas projects (including piped gas networks) | Hong Kong & China Gas (Maanshan) Limited | 50% | US$13.0 million |

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| Name of the PRC Company | Address | Scope of Operations | Foreign Equity Holder | Interest Held by Foreign Equity Holder | Registered Capital |
|---|---|---|---|---|---|
| Weihai Hong Kong and China Gas Company Limited | 3 Qingdaobeilu, Weihai, Shandong province | The construction and operation of piped natural gas and related facilities, the production, processing, storage, transportation, and selling of piped natural gas, the design, production and selling of gas equipment, kitchenware, meters and related equipment, the provision of after sales service, and the design, construction, operation and management of gas storage, transportation and supply facilities | Hong Kong & China Gas (Weihai) Limited | 50% | RMB99.2 million |
| Weifang Hong Kong and China Gas Company Limited | 889 Weizhoulu, Kuimin District, Weifang | The provision of design, installation, supply, maintenance and other related services for city piped gas networks, the storage, processing and supply of city piped gas and cylindered gas, the installation and maintenance of gas equipment and ancillary equipment, and no business shall be conducted during the preparation period | Hong Kong & China Gas (Weifang) Limited | 50% | RMB140.0 million |
| Zibo Hong Kong and China Gas Company Limited | Xipo, Yuhuangshan, Zibo High and New Technology Development Park | The construction and operation of piped natural gas networks and storage facilities, the selling of natural gas, the provision of design, production, selling, installation and maintenance services for kitchenware and other ancillary equipment, and the provision of after sales services | Hong Kong & China Gas (Zibo) Limited | 50% | RMB56.0 million |
| Zibo Lubo Gas Company Limited | North Front, Liuquanlu, Zibo High and New Technology District | The construction and operation of piped natural gas networks and storage facilities, the selling and supply of natural gas, the production of kitchenware and other gas equipment, the selling of products produced by the company | Hong Kong & China Gas (Zibo) Limited | 27% | RMB50.0 million |

Being the birthplace of Confucius and Mencius, Shandong is the cradle of Chinese civilisation. A major province situated on the eastern coast of the PRC, Shandong borders the Huanghe Economic Belt and Bohai Economic Rim and is the meeting point of the northern and eastern PRC regions. It is expected that Shandong will record a growth of 14.5% in GDP in 2006 and rank as the second province after Guangdong that has an economic output of over RMB2,000 billion. Shandong already registered a growth of more than 15% in GDP in 2004 and 2005.

## FUXIN PROJECT

In June 2006, the Group through its wholly-owned subsidiary Panriver Investments Company Limited ("Panriver Investments") entered into an asset transfer agreement with Fuxin City Utilities and Housing Bureau to acquire a 90% equity interest in Fuxin Gas. The project involved a total investment of RMB74,330,000 with an exclusive right to operate gas businesses in Fuxin for 30 years.

Located in the northwestern part of Liaoning province, Fuxin city is 170 kilometres from Shenyang city. Fuxin covers an area of 10,355 square kilometres with a population of 1,930,000. Known as the "City of Coal and Power", Fuxin is renowned for its rich resources and is one of the major energy bases in the PRC. It has a large number of coal mines each boasting an annual production of over 10 million tonnes and is home to major coal-fired electricity plants with a capacity of 700,000 kilowatts each. Apart from coal and charcoal, more than 400 kinds of metallic and non-metallic substances have been found in Fuxin. There are major modern gold and agate refineries in the city. Fuxin is the production and processing base of agate in the PRC accounting for more than 50% of the country's agate reserve. The city is also very rich in coal-bed methane (CBM), which provides an abundant supply for future development of city gas projects.

Fuxin Gas is principally engaged in the development, construction and operation of city piped gas project, and the sale of gas appliances, kitchenware and household electronics. The Group has obtained the necessary approval for the Fuxin project during the year.

## HANGZHOU PROJECT

In June 2006, Panriver Investments entered into an asset transfer agreement with Hangzhou Gas (Group) Company to acquire a 50% equity interest in Hangzhou LPG for a consideration of RMB25,000,000. Upon completion of the acquisition, Hangzhou LPG will be restructured as a sino-foreign joint venture company to be renamed as Hangzhou Panva LPG Company Limited.

Located in the Yangzi River Delta, Hangzhou is the capital city of Zhejiang Province enjoying a sub-provincial status. It is also renowned for its tourist, cultural and historical attractions. There is strong potential for the development of LPG business in Hangzhou both in the domestic and industrial and commercial sectors. Hangzhou recorded a GDP of RMB344.1 billion in 2006, an increase of 14.3% over the previous year, which also represented the 16th year of double-digit growth in the GDP growth of the city. Major industrial enterprises of Hangzhou recorded a

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revenue growth of 24.5% to RMB665 billion during the year, which ranked Hangzhou the PRC's third industrial sub-provincial city following Shenzhen and Guangzhou. The rapid economic growth coupled with a blossoming processing industry provided huge business potential for the LP Gas sector. As a city famous for travel and leisure activities, Hangzhou received 36.82 million tourists in 2006, and the strong establishment of hotels and restaurants and significant flowing population generated substantial demand for the commercial consumption of LP Gas. As at 31 December 2006, the registered population of Hangzhou city amounted to 6,663,100, including an urban population of 4,141,700. The residents in the city and suburb areas of Hangzhou have high living standards and strong consumption power. Moreover, there is basically a unified system in the infrastructure across the city, which gives more accessibility to LP Gas distribution for major towns and villages and the vicinity. Another major advantage of the acquisition of Hangzhou LPG is the operational synergies. Hangzhou LPG mainly uses tank trucks to purchase and transport LP Gas. Given that Hanghzou is only some 500 kilometres from Nanjing, Hangzhou LPG and joined hands with Panva Yangzi and Panva Nanjing to source LP Gas so as to reduce purchasing costs. As such, the acquisition is a valuable addition to the Group both in terms of market development and sourcing.

Hangzhou LPG is principally engaged in the wholesale and retail of LP Gas, the sale and maintenance of gas appliances, and the provision of other value-added services. In 2005, the company's sales volume of LP Gas accounted for about 30% to 40% of the market share in Hangzhou. The Group has obtained the necessary approval for the Hangzhou project during the year.

## AVAILABLE FOR SALE INVESTMENTS

Available for sale investments are mainly made up of the Group's investment in Chengdu City Gas Co., Ltd.

## CORPORATE CULTURE

Panva Corporate Magazine and Panva Institute of Management are the two major means through which the Group cultivates its corporate culture. In 2006, Panva Corporate Magazine was changed from a bi-monthly to a monthly publication. In May, it was granted the "Best Corporate Culture Communication Award" by Nanfang Daily Group, which evaluates the quality of corporate communication of the internal magazines published by the participating enterprises. The Group is particularly pleased with the Award as this is the first time that it participates in the contest in the six years since Panva Corporate Magazine has been published. In November, Panva Corporate Magazine was granted the "Innovative Award of Quality Corporate Publication" in the "2006 Northern Quality Enterprises Internal Communications Award". The award represented a recognition of the communication model of "Example Plus Information" that is adopted by Panva Corporate Magazine.

In May, the Group held its first EMBA course in Beijing Science and Engineering University and the first batch of students included 30 management officers of the Group. Jointly organised by the Group and the University, the course was a good reflection of Panva's corporate culture, emphasizing openness and the importance of learning to achieve openness. The course also represented the beginning of the Group cooperation with the University and as an additional major platform for enhancing internal communications among the Group's enterprises.

In late 2006, Panva Institute of Management opened a branch school in Shenyang. The new school, with technological know-how support from the Group's Changchun subsidiary company, serves as a valuable venue for sharing knowledge and exchanging ideas among the Group's local staff. It emphasizes multi-discipline study, equality of communication, and freedom of expression, providing a convenient location to the Group's managers in the northeastern PRC region to elevate their technical and managerial skills.

Apart from organising standardised professional training courses, the Group also held forums for its staff to promote exchange of ideas and enhancement of corporate culture. In September, the third Panva Forum was held in Beijing addressing the theme of "Professionalism and Teamwork". For the first time, the forum introduced debate and drama as means to stimulate discussion. The forum staged a highly successful and essential gathering for the Group's managers to share their experience, improve their skills, and explore the important concepts of management and administration. During the year, the Group also organised "Panva First Work Meeting on Human Resources", "Panva First Financial Forum", and "Panva Brand Investment Seminar". As a result of these forums, the Group's managers became more forthcoming and innovative, and attained higher professionalism.

## CUSTOMER SERVICE AND SAFETY MANAGEMENT

During the year, the Group achieved major breakthroughs in customer service. In March, Nanjing Panva and China Unicom Nanjing Co Ltd jointly issued a smart card, the Panva Unicom Value Card, which received favourable response from the public. In February 2007, Shenzhen Huaxinlian Investment Limited Liability Company, an associate of Panriver Investments, was approved by the Ministry of Information Industry to use the special number "95007" for customer service. The Group's first batch of companies operating in eight PRC provinces will enter into cooperation agreements with Shenzhen Huaxinlian Investment Limited Liability Company to use the number, which will enable a unified hotline number for all customers using the Group's gas fuel services. The eight provinces include Jiangsu, Anhui, Shandong, Hunan, Guangdong, Guizhou, Yunnan, and Sichuan, where over 40 companies of the Group are providing gas fuel services. In the future, as the Group unify its service hotline across the country, more coordinated services will be provided to customers. This will help the Group enhance its software and hardware for better customer service and strengthen the Group's position as a nationwide brand for gas fuel operations in the PRC.

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As regards to engineering requirements, the Group has devoted significant efforts in implementing the "Engineering Management Manual". Staff members at some of the Group's piped gas companies have been equipped with a manual and they have made necessary changes to engineering operations. For instance, the unclear signage and third party damage on the vaulted facilities of the long gas pipelines have been amended and repaired.

To promote safety awareness, the Group's joint venture companies have organised fire drills with the local fire department authorities. Some joint venture companies conducted the safety campaigns in schools, communities, food caterers and entertainment venues U.C. Site inspections of gas supply facilities were carried out ensure safety.

## CONTINGENT LIABILITIES

The Group has no material contingent liabilities as at the balance sheet date.

## FINANCIAL POSITION

As at 31 December 2006, the Group's cash and cash equivalents amounted to approximately HK$614.5 million which were mostly denominated in Renminbi, Hong Kong dollars and United States dollars.

As at 31 December 2006, the Group's bank loans and other borrowings amounted to approximately HK$2,062.7 million, of which approximately HK$1,906.9 million arose from the issue of guaranteed senior notes in September 2004 and the Group's issue of 5-year convertible bonds in April 2003. The Group ended the year under review with a current ratio of approximately 1.7 times and a gearing ratio (net debt to equity attributable to shareholders of the parent company) of approximately 94.2%.

Total assets pledged in securing these bank loans had a net book value of approximately HK$30.0 million as at 31 December 2006.

## EMPLOYEES AND REMUNERATION POLICIES

As at 31 December 2006, the Group had 7,988 employees, an increase of 4,170 from a year ago. Approximately 99% of the Group's employees worked in the PRC. The Group offers remunerations based on performance, job nature and responsibility. Moreover, the Group provides training and various benefits for its employees including medical care, provident fund, bonus and other incentives. The Group also encourages its employees to pursue a balanced life and provides a good working environment for its employees to maximise their potential and contribution to the Group.

## PROSPECTS

Looking ahead, the Group's integration with HKCG is expected to bring the following benefits to the Group:

- It further strengthens the Group's position as a leading operator of piped gas business in the PRC. After the transaction, the Group has a robust portfolio of 35 piped gas projects in 32 cities serving over 1.7 million users in the PRC.

- It creates a super-regional footprint across the northeastern and eastern PRC regions for the Group, which will be able to extend its presence across the near contiguous provinces of Heilongjiang, Jilin, Liaoning, Shandong, Anhui and Jiangsu in addition to the Group's significant operations in Sichuan province.

- With HKCG as a significant shareholder in Panva, the Group stands to benefit from HKCG's experience, operational expertise and considerable financial resources and focus on operational improvements and enhance internal controls and risk management. It also creates operational synergies such as the centralization of capital expenditure management and leverage with vendors, suppliers and service providers.

- HKCG's considerable financial strength and financial management experience will enable the Group to reduce its funding costs.

- With the combined efforts in marketing and the expanding networks and assets, the two companies can support and complement each other while each develops its own best platform to maximise the operational synergies and brand advantages.

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- HKCG has strong track record and experience in safety management and engineering, which will be beneficial to the Group to improve its operational standards in a systematic and scientific manner.

- By having access to HKCG's operational expertise, business know-how and managerial support, the Group will be able to bring its operations to improve competitiveness and further strengthen its leading position in the gas fuel business.

- The Group will be able to realign its internal resources, reduce its purchasing costs and improve its operating efficiencies.

## FINAL DIVIDEND

In light of the enormous investment opportunities in the city piped gas networks in the PRC, the Board does not recommend the payment of a final dividend for the year ended 31 December 2006 (2005: Nil).