



MANAGEMENT



THE COMPETENT AND **PROFESSIONAL** MANAGEMENT TEAM LEADS TO EFFICIENT GROWTH

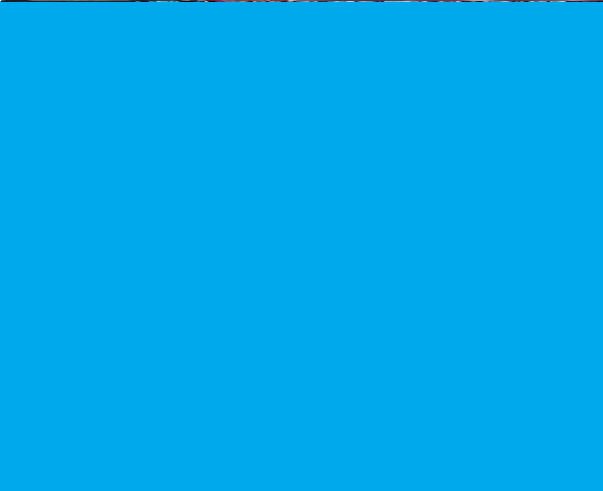




ECONOMICAL



COMPETITIVE PRICING AND AFFLUENT
RESERVES OF NATURAL GAS MAKE IT A
PRIMARY ENERGY SOURCE



MANAGEMENT DISCUSSION AND ANALYSIS

INDUSTRY REVIEW

ENERGY CONSUMPTION PATTERN IN THE PRC

The PRC is the second largest energy consumer in the world, and its major sources of energy are coal, crude oil and natural gas. Coal accounted for approximately 70% of the PRC's total energy consumption in 2001. The use of coal severely pollutes the environment, while natural gas is among the cleanest, safest, most efficient and economical energy sources. The exploration in 2000 has evidenced that the reserve of natural gas is more abundant than the oil reserve available for extraction by approximately 20 years. The PRC government is actively promoting the use of natural gas as a clean fuel.

THE NATURAL GAS POLICY IN THE PRC

The W-E is the established policy of the PRC government for advocating the use of natural gas. It is expected that when the project is completed in 2004, the pipelines will pass through cities in 10 provinces and significantly extend the coverage of provinces or cities that will have access to natural gas. Before the gas source is connected, we will continue to actively capture the downstream market of W-E and supply compressed natural gas (CNG) or liquefied natural gas (LNG) to those customers as a transitional gas source, so that once the pipelines are set up, the Group will be able to supply natural gas to them more efficiently and at lower cost.

At the end of 2002, the Ministry of Construction of the PRC issued the memorandum of "Opinion concerning the speeding up of the development of market economy in the public utilities sector" which primarily required local authorities to open up the market for the construction and operation of public utilities, while allowing foreign investors to set foot in the market, including the city gas industry, by establishing wholly-owned enterprises, equity joint ventures or cooperative joint ventures. As a result, we believe that the city piped natural gas market will enjoy even more rapid and healthy development as the city gas industry is becoming more market-oriented. The PRC government is establishing a regulatory framework to cope with reforms towards a market economy for natural gas industry.

At the end of 2002, Xinao Gas was invited to attend the third conference of the China Britain Natural Gas Working Group (CBNGWG) organised by the British government in London. Discussion in the conference focused on the construction and operation of infrastructure for city natural gas, safety issues and the market development within the industry. The major objective of the CBNGWG in convening the conference was to promote the reform of the natural gas industry in the PRC. Attending the conference provided Xinao Gas with an opportunity to share its experience and discuss topics of common interest with relevant Chinese and British governmental organisations and leaders in the industry. The conference prepared Xinao Gas to assume an active role in the future reform of the natural gas industry in the PRC. Xinao Gas was the only Chinese private piped natural gas distributor being invited to attend the conference. This distinguished Xinao Gas from other gas companies and demonstrated its leading position in the market.



BUSINESS REVIEW

The principal business of the Group is the construction of gas pipelines, the sale of piped gas, the sale of liquefied petroleum gas ("LPG") and the sale of gas appliances and equipment.

CONSTRUCTION OF GAS PIPELINES

RESIDENTIAL CUSTOMERS

The Group charges connection fees for constructing gas pipelines that connect the processing stations and the residential households. As the Group is the sole piped gas distributor serving the entire city, the residential customers include both the newly constructed and existing buildings. Our target is to achieve a high penetration rate of natural gas usage in each project city so as to protect the environment. In the 29 existing project cities, most of the local governments have prescribed the installation of piped natural gas as one of the conditions for approving the construction of new buildings. This policy will continue to assist the Group in raising the penetration rate and stabilising the revenue from connection fees, which are collected from the property developers directly.

During the year, the Group made connections to 102,849 residential households, 95.2% higher than last year. The average connection fee paid by households was RMB2,592, slightly decreased by 2.8% as compared to last year. The primary reason for the decrease of the average connection fee was that we were trying to increase our market share rapidly: We offered special rates to increase the penetration rate and further promote the use of natural gas. As at the end of 2002, we provided natural gas connections to a total of 210,850 households, which accounted for 7% of the overall connectable population of the Group.



Our industrial customers use natural gas for metal molding, and it greatly saves costs and increases production efficiency

COMMERCIAL/INDUSTRIAL CUSTOMERS

Organisations engaging in industrial production and commercial activities, such as factories, shopping malls, schools, hospitals, hotels and motor vehicle manufacturers, etc., continue to be the major commercial/industrial customers of the Group. Since the selling price of natural gas is substantially lower than other energy sources, such as electricity, coal gas and LPG, many commercial/industrial customers are willing to switch to use natural gas. Unlike LPG, natural gas is more difficult to transport and store, and as a result, customers can only get access to natural gas through our pipeline network. This has led to natural monopolisation. During the year, we provided natural gas connections to a total of 147 commercial/industrial customers (connected to a total installed designed daily capacity of 95,366 m³ of gas appliances). The average connection fee was RMB575 per cubic metres, 27.2% higher than last year. The increase reflects that customers are attracted to use natural gas because the price of natural gas is more competitive than other sources of energy, and commercial/industrial customers with huge consumption can lower their cost substantially in the long run.

As at the end of 2002, we provided piped natural gas connections to a total of 502 commercial/industrial customers (connected to a total installed designed daily capacity of 365,113 m³ of gas appliances).

NEW PROJECTS

In 2002, the Group continued to take an active role in the exploration of new projects, and the connectable population grew 1.8 times from 3.4 million (approximately 1.13 million households) to 9.5 million (approximately 3.16 million households) by the end of 2002. This can stabilise the Group's future income and consolidate its customer base. New projects secured by the Group in 2002 are as follows:

Hebei Province	Shijiazhuang (provincial capital)
Jiangsu Province	Yancheng, Huaian, Haian, Xinghua*
Zhejiang Province	Anji, Quzhou,* Haining*
Anhui Province	Chuzhou, Luan, Bozhou*
Shandong Province	Rizhao
Henan Province	Xinxiang
Liaoning Province	Xingcheng

**not yet commenced operation*

Shijiazhuang is the first provincial capital project of the Group. This has demonstrated the government's recognition of the Group's management ability, operation safety and financial strength. The securing of the Shijiazhuang project helps the Group to obtain other large scale projects in the future. Projects in operation increased from 12 in last year to 25 in 2002, paving the way for continuous expansion of the Group.

SALE OF PIPED GAS

During the year, we sold 19.1 million m³ and 30.4 million m³ piped gas to residential households and industrial/commercial customers respectively, representing increases of 35.7% and 48.4% as compared to last year. The ratio of the sales of gas for industrial/commercial customers further increased from 58.8% in last year to 63.8%, laying a solid foundation for the Group's long term revenue.

As the PRC economy will continue to grow rapidly in the coming years, and thereby stimulating the property market and the business of the industrial/commercial customers, the demand for a clean fuel will grow tremendously. The gas sales volume for industrial/commercial customers will be much higher than residential households, and the Group will continue to develop the markets of both residential households and industrial/commercial customers so as to have a strong revenue structure and a stabilised cash flow.

ADVANCED GAS USAGE CHARGE COLLECTION SYSTEM

The Group continues to adopt the prepaid stored-value card system for the new projects. Under the system, all residential customers will receive a stored-value card and are required to prepay for the gas usage charges. This system can totally eliminate the possibility of default payment and save huge administrative expenses, thus improving the Group's cash flow position.

SALE OF LPG

The Group has been principally engaged in the sale of piped natural gas. As the gross profit margin and the net profit margin of LPG are relatively low, LPG is only sold in certain cities as a transitional gas source. At present, Bengbu Xinao Gas Company Limited (established in December 2001), Huaian Xinao Gas Company Limited (established in May 2002) and Xinxiang Xinao Gas Company Limited (established in September 2002) are all engaged in the wholesaling and retailing of LPG. Before being taken over by the Group, the principal business of these companies was the sale of LPG. They have all started to construct natural gas pipelines after the Group's acquisition. The Group expects that the sales of LPG of these projects will gradually be replaced by piped natural gas. 43,489 tons of LPG were sold by the Group during 2002.

SALE OF GAS APPLIANCES

The Group sells cooking stoves, water heaters, boilers and stored-value card meters besides providing gas connections. During the year, the Group sold a total of 31,655 cooking stoves, 4,178 water heaters and 4,164 boilers. Most of the meters produced were used by the Group when making connections.

The Group established a stored-value card meter factory in June 2001, and the production capacity of the factory will reach 200,000 in 2003. The factory mainly supplies the meters to be installed in residential households when the Group makes gas connections. Customers can have gas supply when they insert their prepaid stored-value cards into the meters. After the establishment of the production line, the average cost of stored-value card meters dropped by 34%. The connection costs of the Group are substantially lowered when taking into account of more than 100,000 households being connected annually. Besides, among the stored-value card meters sold in 2002, 2,652 were sold to other gas distributors. The production of stored-value card meters not only reduces costs, but also generates additional income for the Group.

GROSS PROFIT MARGIN AND NET PROFIT MARGIN

The Group's overall gross profit margin decreased from 59.5% in 2001 to 46.8% in 2002. The main reason for the decrease was that the Group was engaged in the

We have our own factory to produce quality stored-value card meters for our customers



sale of LPG during the year. Excluding LPG, the overall gross profit margin for connection fees, sales of piped gas and sales of gas appliances maintained at 62.0%, representing a slight increase over last year. The increase was the result of stringent control over pipeline construction costs and the adoption of advanced operation management system by the Group.

The Group's net profit margin decreased from 33.0% in last year to 23.5% this year. The reasons for the decrease in net profit margin and gross profit margin were the same: the sale of large amount of LPG during the year. Excluding LPG, the net profit margin maintained at 34.7%.

Analysis of the gross profit margin and the net profit margin in 2002:

	For the year ended 31 December			
	2002	Percentage	2001	Percentage
	(000'RMB)		(000'RMB)	
Turnover	544,492		240,560	
Connections fees	330,915	60.8%	184,796	76.8%
Sales of piped gas	73,588	13.5%	50,594	21.0%
Sales of gas appliances	9,544	1.7%	5,170	2.2%
Sales of LPG	130,445	24.0%	-	-
Gross profit margin (ex-LPG)	62.0%		-	
Gross profit margin	46.8%		59.5%	
Net profit margin (ex-LPG)	34.7%		-	
Net profit margin	23.5%		33.0%	

We emphasise communication with our customers and listen carefully to their needs in order to provide the best quality customer services



OPERATION MANAGEMENT

The Group recognises the importance of safe and efficient operation management in the gas industry. To further enhance our operation management, Liaocheng Xinao Gas Company Limited (“Liaocheng Xinao”) and Huludao Xinao Gas Company Limited (“Huludao Xinao”) obtained the ISO9001 certifications in 2002. Together with Langfang Xinao Gas Company Limited (“Langfang Xinao”), 3 project companies of the Group have obtained this certification. Other project companies are complying with the ISO9001 Standards in normal daily work.

By organising customer opinion campaign, we have collected useful opinions on pipeline installation within the buildings, pipeline network construction and after-sales services from the customers.

ADVANCED MANAGEMENT SYSTEM

Xinao Gas has maintained excellent safety track record for the past 10 years of operations. This is not achieved by mere chance, but by the Group’s stringent administration control and the management’s innovative ideas. We have computerised daily operation work, especially the supervision and adjustment of pipeline pressure of gas processing stations and daily maintenance. Safe and efficient operation management has become one of the competitive edges of Xinao Gas in securing new projects.

Because of our outstanding management, Xinao Gas has once again won numerous awards from various international financial magazines. The Company was awarded by *FinanceAsia* as one of the “10 Best Financial Management” in 2002. Since the selection was based on the votes of more than 300 professional investors from international financial institutes, it fully demonstrates the Group’s strength in financial management. The Group also received numerous awards for the second consecutive year from other renowned financial publishers including “The 200 Best Small Companies” by *Forbes Global*, the “Best Small Companies in the PRC” by *AsiaMoney* and the “Top 500 Chinese Enterprises in the World” by *Yazhou Zhoukan*. Xinao Gas was also awarded the “Top 20 Chinese Enterprises of Revenue Growth” by *Yazhou Zhoukan* in 2002 for the first time.

It was not easy to obtain such achievements, but the Group’s management will endeavour to maintain our outstanding performance.

CUSTOMER SERVICES

Quality customer services are crucial to the Group for establishing long-term relationship with its customers. The Group is well aware of this and has devoted efforts to maintain quality services of high efficiency and safety standards.



Quality customer services give our customers high confidence

In the year 2002, Liaocheng Xinao and Huludao Xinao followed the footsteps of Langfang Xinao to launch the “95158” national 24-hour customer services hotline. Our customers can simply dial 95158 to access the local 24-hour customer services centre and contact us more conveniently. In case of emergency, we promise to arrive at the site to carry out maintenance work within 20 minutes. Our emergency-repair cars are approved by the local governments to be equipped with sirens similar to those on the police cars, so that we will be able to arrive at the site early in an emergency.

The Group also conducted regular safety checks on pipeline networks and customers’ gas appliances and issued new leaflets of “Gas Usage Safety Standards” to our customers during the year. These preventive measures fully embodied the principle of “prevention is always better than cure”. Therefore, our maintenance fees remained at a low level. During the year, we organised the “Xinao Gas Environmental Quiz” with the aim to increase customers’ knowledge on the use of natural gas and to enhance relationship between the Group and the customers.



Internal training can further increase the core competitiveness of our staff and make them grow together with the Company

HUMAN RESOURCES

We believe that quality human resources are the key to the Group's continuous success and future development, so we put great emphasis on recruitment and internal training.

Every year, we recruit undergraduates from renowned gas specialties of universities all over China as well as professionals in the industry or from overseas according to our development needs. All new staff will be given internal training and may be deployed to different departments to have a good understanding of the Group's culture and operations, so as to provide quality customer services and ensure smooth operation of the Company.

The Group encourages staff to have lifelong learning. We have sponsored some employees to study for MBA in renowned universities or to attend other related technical courses, so as to enhance their competence, technical skills and quality.

The Group also invites university professors to give in-house training courses to ensure our staff work with practical theory. Work reviews and assessments with staff are also held regularly to rectify any problems at an early stage. Forums provide another platform for staff to communicate with the management, so that the Group can make appropriate adjustments.

Furthermore, family members of the employees are invited to attend various functions, such as seminars or dinner parties, held by the Group with the aim to strengthen communications and affections between staff and company, and to enhance the sense of belonging of staff towards the Group.

As at 31 December 2002, the Group had 3,238 employees, five based in Hong Kong while the others based in the PRC. They were remunerated at market level with benefits such as bonus, retirement benefits and share option scheme.

FINANCIAL RESOURCES REVIEW

LIQUIDITY AND FINANCIAL RESOURCES

As at 31 December 2002, the Group had abundant capital with net cash of RMB164.1 million (2001: 59.3 million) available for future development. Therefore, the net gearing ratio of the Group was zero (2001: zero). In March 2002, the Company placed 110 million shares to international assets management companies and professional investors at HK\$3.05 per share and the net proceeds was HK\$326 million.

Uses of the proceeds are as follows:

Proposed uses on placement	Planned use of proceeds as set out in the placement	Actual use of proceeds	Difference
	HK\$'000	HK\$'000	
1. Invested in Huaian Xinao Gas Company Limited (Huaian Xinao), Jiangsu Province	70,000	22,642	47,358
2. Invested in Yancheng Xinao Gas Company Limited (Yancheng Xinao), Jiangsu Province	60,000	7,547	52,453
3. Invested in the new gas projects in Anhui Province	90,000	107,566	(17,566)
4. Invested in the new gas projects in Jiangsu Province	90,000	14,085	75,915
5. General working capital	16,000	16,000	-
	326,000	167,840	158,160

Reasons for difference between planned usage of proceeds and actual utilisation are set out below:

- The registered capital of Huaian Xinao is RMB30 million (approximately HK\$28 million). The Group owned 80% of the equity interest with a total investment of RMB60 million (approximately HK\$56 million), which is less than HK\$70 million as originally estimated. The difference between the total investment and the registered capital is RMB30 million (approximately HK\$28 million). Since there is no need to invest such amount at this stage, the Group has invested the excess amount in Rizhao Xinao Gas Company Limited in Shandong Province and Haining Xinao Gas Company Limited in Zhejiang Province as part of their registered capital.
- The registered capital of Yancheng Xinao is RMB50 million (approximately HK\$47 million). The Group owned 80% of the equity interest with a total investment of RMB120 million (approximately HK\$113 million). The difference between the total investment amount and the registered capital is RMB70 million (approximately HK\$66 million), which needs not to be invested at this stage. However, the Group still has to invest a registered capital of RMB32 million (or approximately HK\$30 million) into Yancheng Xinao later. The excess amount of HK\$22 million has been invested in Xinxiang Xinao Gas Company Limited in Henan Province as part of its registered capital.
- As the Group has secured more projects in Anhui Province and such projects are larger in scale, the capital actually injected is higher than originally estimated.
- The Group has invested the excess amount of capital in Quzhou Xinao Gas Company Limited in Zhejiang Province and Shijiazhuang Xinao Gas Company Limited in Hebei Province as part of their registered capital.

The proceeds from the listing of the Company on the GEM of the Stock Exchange in May 2001 have been invested as originally planned.

Since the annual interest rate continues to fall and stay at a low level, Xinao Gas, in order to cope with the Group's future development, obtained a three-year, unsecured syndicated loan of US\$30 million in September 2002. It is expected that the loan, when aggregated with the Group's internal resources and bank borrowings, is sufficient to finance the future operational and capital expenditure.

BORROWINGS STRUCTURE

As at 31 December 2002, the Group's total bank and other borrowings amounted to RMB467.4 million (2001: RMB123.1 million), including a three-year syndicated loan of US\$30 million signed on September 2002 (equivalent to RMB248.0 million), which bears interest at a floating rate. The remaining borrowings are denominated in Renminbi granted by local banks in the PRC to the project companies as their working capital and operational expenditure. Except for a loan amount of RMB49.3 million that has to be secured by a net asset value of approximately RMB73.6 million, all of the other loans are unsecured with an interest rate from 5.0% to 6.5%. Short-term loans amounted to RMB202.0 million while the remaining were long-term loans falling due after more than 1 year.

As all the operations of the Group are in the PRC, revenues and expenses are mainly denominated in Renminbi. Hence, there is no significant foreign exchange fluctuation exposure except for the three-year syndicated loan of US\$30 million. After evaluating the future movement of foreign exchange, the Group's management considers that there is no need to make any foreign exchange hedge in respect of the syndicated loan of US\$30 million at present, but the Group will continue to pay attention to such risks and make foreign exchange hedge if necessary. Therefore, the Group has not entered into any financial contract or other arrangement to hedge foreign exchange risks.

CONTINGENT LIABILITIES

During the year, the Group had given guarantee to a bank in respect of banking facilities granted to a third party to the extent of RMB39.5 million (2001: nil). An amount of RMB37.5 million has been released subsequent to the balance sheet date.



SAFETY



IN ADDITION TO A COMPREHENSIVE MONITORING SYSTEM, THE **SAFE AND EFFICIENT** CHARACTERISTICS OF NATURAL GAS ENSURE MAXIMUM SAFETY FOR CUSTOMERS.





CLEANEST



**THE USE OF NATURAL GAS HELPS
REDUCE THE HARMFUL EMISSIONS
AND SAVE THE ENVIRONMENT**

