

# THE POWER FOR LIFE

>18:30pm



>19:17pm



>19:32pm



>20:11pm



NATURAL GAS CAN BE USED FOR COOKING, BOILING AND HEATING IN HOUSEHOLDS. IT SAVES LARGE PORTION OF EXPENSES EVERY MONTH WHEN COMPARING TO OTHER ENERGY SOURCES LIKE ELECTRICITY, LPG AND COAL GAS.

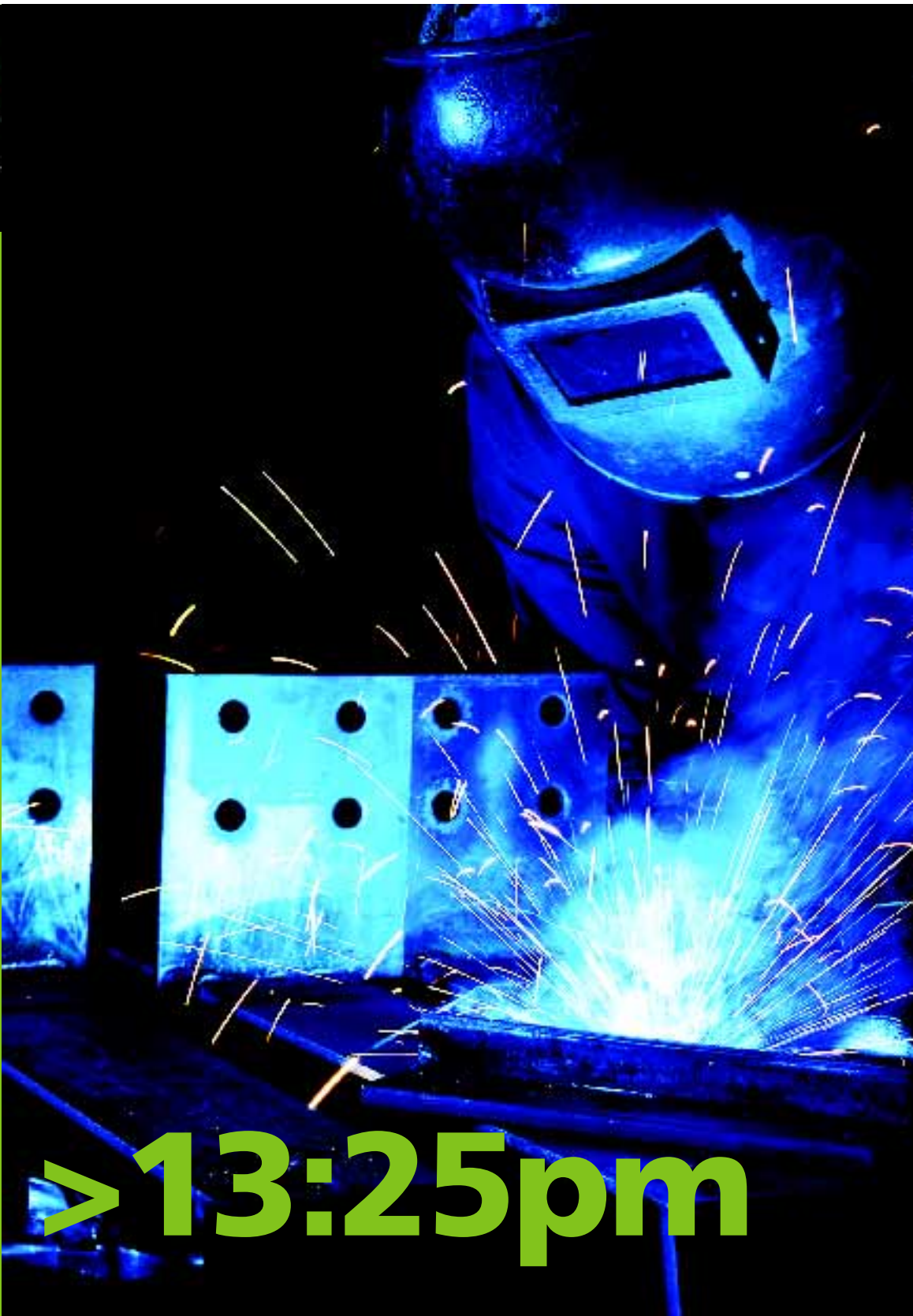


**>20:00pm**

THE POWER FOR

# PRODUCTION

>18:30pm



>13:25pm



&gt;19:32pm

&gt;20:11pm



WITH THE COMPLETION OF WEST-TO-EAST PIPELINES, MORE INDUSTRIAL USERS WILL BE ABLE TO USE THIS CLEAN, SAFE, EFFICIENT AND ECONOMICAL ENERGY SOURCE TO FURTHER INCREASE ECONOMIC EFFICIENCY.

MANAGEMENT  
DISCUSSION  
AND ANALYSIS

>00:30am

>09:27am

# THE POWER OF MANAGEMENT



&gt;22:00pm



## 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. The use of coal severely pollutes the environment, while natural gas is among the cleanest, safest, most efficient and economical energy sources; therefore, the PRC government is vigorously promoting the use of natural gas as a clean energy source.

According to the official estimates of GDP growth and energy demand growth in the Tenth-Five period, natural gas consumption in the PRC is expected to increase from 22.1 billion m<sup>3</sup> in 1998 to 50 billion m<sup>3</sup> in 2005, representing around 4.5% of the total energy consumption in the PRC. Comparing to the Ninth-Five period, the annual growth rate of natural gas consumption in the Tenth-Five period will be 13.0%, and the ratio of natural gas consumption to total energy consumption will rise to around 7% by 2010.

### THE NATURAL GAS POLICY IN THE PRC

At the end of 2002, the Ministry of Construction of the PRC issued a memorandum on the "Opinion concerning the speeding up of the development of market economy in the public utilities sector" requiring local authorities to open up

the market for the construction and operation of public utilities, including city gas. Foreign investors are now allowed to take a majority stake in or completely own such projects. Therefore, the Group believes that with the liberalisation of the city gas market, city piped natural gas in the PRC will have even faster and healthier development.

The government's policy not only suggests the pace of market liberalisation in city gas industry is proceeding fast, but also implies a full legal framework on city gas distribution will be formed soon. There will be a monitoring system on natural gas that can match up the market reform and also a legitimate means of protection to gas companies. We are confident that with the central government's encouraging policy, piped natural gas market will have further development, and the investment risks for gas operators will be further reduced.

The "West-to-East Pipelines" ("W-E") is one of the policies showing the PRC government's support for the use of natural gas. The long distance pipelines of this project started to supply natural gas in 2003, and the construction of the branches is under progress. W-E passes through cities in 9 provinces and Shanghai Municipality and greatly increases the number of cities being able to use natural gas.

## MANAGEMENT DISCUSSION AND ANALYSIS

>13:52pm



Our strong piped gas distribution networks lay a solid foundation for gas sales revenue.

The operation of W-E project and the smooth progress of plans of exploring natural gas under seabed and importing liquefied natural gas (LNG) from overseas, together with central and local governments' emphasis on using natural gas and higher popularity of natural gas among consumers, will help the rapid and continuous development of downstream natural gas business. As a result, the Group will have even greater business development prospects.

During the year, the Group cooperated with Utilise Training & Development Solutions Limited, a professional training institute in the UK, and introduced advanced training system on gas profession from the UK into the PRC. This training was a cooperative program between the Chinese and British government, and its implementation was highly supported by the Ministry of Construction. This proves the Group's leading position in the industry and its good relationship with the government.

All the above reflect Xinao Gas' distinguished and leading position in the PRC gas market, its increasing brand name and influence on the industry, and its status as one of the largest gas operators in the PRC.

### BUSINESS REVIEW

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

#### CONSTRUCTION OF GAS PIPELINES

During the year, in order to enhance market planning for connection business and speed up the development of this business, the Group worked with a consultancy firm launching a marketing project, the implementation of which will have significant effect on the Group's growing performance on connection business in the future.

As the households connected to natural gas only accounted for 7.4% of the total connectable households, it is expected that the Group will continue to have huge revenue from connection, and it will continue to be the major revenue source of the Group. However, the Group's sales of natural gas will increase rapidly when the W-E fully commences gas supply in 2004, and the Group expects the proportion of connection revenue to remain about the same with slight increase.

&gt;20:22pm

&gt;23:41pm



Stable natural gas sources facilitate us to explore more commercial/industrial customers.

#### 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 buildings and the existing buildings. Our target is to achieve a high penetration rate of natural gas usage in each project city, and to protect the environment as a result. Most of the local governments in the 41 existing project cities have prescribed the installation of piped natural gas as one of the conditions for approving the construction of new buildings. This policy shows clearly the government's support for the use of natural gas and will assist the Group further in raising the penetration rate and stabilising the revenue from connection fees, which are collected from the property developers directly.

As natural gas is more environmentally-friendly, economical, convenient and safer when comparing to other energy sources, more and more residential households take the initiative to get connected to piped natural gas, and flats connected to piped natural gas have become popular and are preferred by new home buyers. These boost the connection business of the Group and lower the Group's cost for getting new customers.

During the year, the Group made connections to 170,433 residential households, 65.7% higher than last year. The average connection fee paid by households was RMB2,687, slightly increased by 3.7% as compared to last year. The primary reason for the increase of the average connection fee is that apart from cooking stoves, customers also choose to get connected to boilers and heaters, which are of higher price. This shows once more the popularity of natural gas among customers.

As at the end of 2003, the Group provided natural gas connections to a total of 381,283 households, which accounted for 7.4% of the overall connectable population of the Group.

#### COMMERCIAL/INDUSTRIAL CUSTOMERS

Organisations engaging in industrial production and commercial activities, such as factories, hotels, shopping malls, schools and hospitals, 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 access to natural gas through our pipeline network, which facilitates the connection business.



## MANAGEMENT DISCUSSION AND ANALYSIS

>05:33am

>11:47pm

Also, as many local governments in the PRC have devoted much attention to environmental protection in recent years, they have put more efforts in controlling industrial pollution. Many of them do not allow the use of coal as an industrial fuel any more and do not grant permissions to the setting up of new commercial/industrial projects that are not using clean energy. In addition, W-E is going to supply natural gas to cities along the pipelines, and the supply of natural gas will not be restrained by the lack of gas source as in the past. The positive measures and more stable gas source will all help the Group's business development in connecting commercial/industrial customers.

During the year, the Group provided natural gas connections to 280 commercial/industrial customers (connected to gas appliances of a total installed designed daily capacity of 167,680 m<sup>3</sup>). The average connection fee was RMB511 per cubic metres, 11.1% lower than last year. The main reason for the decrease was that the Group offered discounts to commercial/industrial customers to increase the rate of connection because they will consume huge volume of gas and become the major gas users.

As at the end of 2003, the Group provided piped natural gas connections to a total of 782 commercial/industrial customers (connected to gas appliances of a total installed designed daily capacity of 532,793 m<sup>3</sup>).

### NEW PROJECTS

In 2003, the Group continued to take an active role in the exploration of new projects. The Group's projects increased from 29 last year to 41 this year, and the connectable population grew tremendously by 98.8% from 9.5 million (approximately 3.16 million households) to 18.7 million (approximately 6.23 million households) by the end of 2003. This further stabilises the Group's future income, consolidates its customer base and makes the Group one of the professional city gas operators in the PRC covering the largest population.

New projects secured by the Group in 2003 are as follows:

Hunan Province	Changsha*, Xiangtan, Zhuzhou
Jiangsu Province	Lianyungang, Changzhou
Zhejiang Province	Wenzhou, Jinhua, Lanxi
Guangdong Province	Dongguan
Anhui Province	Chaohu
Shandong Province	Jiaozhou, Jiaonan
Henan Province	Kaifeng

\* Provincial capital

Project disposed by the Group in 2003 is as follows:

Zhejiang Province	Anji
-------------------	------

The new projects the Group obtained during the year are mainly located along the W-E long distance pipelines or its branches that are under construction. During the year, three of the Group's subsidiaries, Xinxiang Xinao Gas Company Limited ("Xinxiang Xinao"), Chuzhou Xinao Gas Company Limited ("Chuzhou Xinao") and Changzhou Xinao Gas Company Limited ("Changzhou Xinao"), started to use the natural gas transmitted by W-E Pipelines. It does not only guarantee stable gas source, but also offers lower cost for higher profit for the Group.

Changsha Project is the second provincial capital project of the Group after Shijiazhuang Project obtained last year. This has demonstrated once more the government's recognition of the Group's management ability, operation safety and financial strength. The securing of the Changsha Project makes the Group a more professional gas operator with larger scale and paves the way for the Group for obtaining other large city projects.

Comparing to 2002, the new projects obtained in 2003 were larger in scale and higher in quality. Projects like Xiangtan, Zhuzhou, Lianyungang, Wenzhou, Dongguan and Kaifeng are cities with strong economy, well-developed industries and high population, and they pave the way for the Group

## >18:55pm

for its future expansion in connection business. Also, the Group put more emphasis on the development of city groups as a whole, such as "Changsha-Zhuzhou-Xiangtan" golden triangle and the city chain of Jiaozhou Bay, which facilitate better gas sources and management of the projects and create an environment for sharing resources and advantages.

During the year, the Group's strategies were gradually moving towards projects of medium to large scale with its continual expansion in business scope and successful development of new projects. As the operation of Anji Xinao Gas Company Limited ("Anji Xinao") was relatively small in scale with a population of 120,000, in order to consolidate various resources of the Group, including management, financial and human resources etc., the Group decided to dispose its entire interests in Anji Xinao and re-deploy its resources into other projects. The Group planned to apply the proceeds of the disposal for use in the general working capital of the Group.

To strengthen the Group's professional management, the project company in each location has split into two. This split separates the pipeline construction business and gas distribution business of each original project company into two companies, and the different professional teams can manage and operate the corresponding companies more professionally, so resources can be used more effectively. When the split is finished, the number of subsidiary companies will double, but the number of operation locations will remain the same.

### SALE OF PIPED GAS

During the year, the Group sold 45.0 million m<sup>3</sup> and 71.6 million m<sup>3</sup> piped gas to residential households and industrial/commercial customers respectively, representing increases of 1.4 times respectively over last year. The ratio of the sales of gas for industrial/commercial customers was 61.4% and remained about the same as in last year, laying a solid foundation for the Group's long-term revenue. As W-E will commence gas supply fully in 2004 and eliminate the restraint on gas source, the Group expects the volume of gas sales will further increase in the future. The strong increase in

natural gas sales during the year did not just come from quality new projects the Group had successfully obtained, but also from successful marketing in existing projects. The high growth in the sales of natural gas also fully reflected that the use of natural gas as a quality energy source was highly recognised by the public.

As the PRC government is getting more concerned on environmental problems, and its economy continues to grow rapidly in the coming years and thereby stimulates the property market and the business of the industrial/commercial customers, the demand for a clean energy source 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.

### CNG vehicle gas station

The Group has started the operation of compressed natural gas ("CNG") vehicle refuelling stations ("refuelling stations") in Langfang City, Hebei Province since two years ago, and 660 taxis and 120 buses have been converted into CNG vehicles. As the price of natural gas is 20-30% lower than gasoline, it is highly welcome by bus companies and taxi owners. With two years of successful experience, the Group plans to launch gas refuelling business in our existing operation locations in 2004 and intends to build 19 refuelling stations in Langfang, Liaocheng, Bengbu and Shijiazhuang during 2004. This will have very positive impact on the Group's business as it increases further the sales of natural gas and guarantees long-term revenue in the future. The Group can utilise our existing resources, including gas stations, pipeline networks, gas sources, human resources, brand name, etc., when developing refuelling business in our operating locations. Since vehicle emission is a major source of pollution, it is believed that the PRC government will promote the conversion of CNG vehicles and accelerate the development of refuelling business. The Group expects that refuelling business will become one of the major components in our gas sales business.

# MANAGEMENT DISCUSSION AND ANALYSIS

>21:57am

## Advanced collection system for gas usage charge

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

## SALE OF LPG

During the year, the Group sold 52,693 tons of LPG, increasing 21.2% over last year. The Group has been principally engaged in the sale of piped natural gas, and LPG is only sold in certain cities as a transitional gas source, as the gross profit margin and the net profit margin of LPG are relatively low. Bengbu Xinao Gas Company Limited ("Bengbu Xinao"), Huaian Xinao Gas Company Limited ("Huaian Xinao") and Xinxiang Xinao are engaged in the wholesaling and retailing of LPG, and the sales volume of these three projects accounted for 92.1% of the total volume of LPG sales. 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, and LPG are only sold to customers not connected to natural gas or to the peripheral towns. The Group expects that the sales of LPG of these projects will gradually be replaced by piped natural gas, and the present ratio of LPG sales volume to piped natural gas sales volume in these projects were 80% to 20% on average.

The operating result of LPG turned around from a loss of RMB1,874,000 in 2002 to a profit of RMB369,000 during the year; the main reason for turning loss into profit in LPG sales was that Bengbu Xinao, by the time it was set up, was allowed to raise the selling price of LPG by 20% starting from May this year, and the LPG sales volume made by Bengbu Xinao accounted for 37.5% of the total volume of LPG sales.

## SALE OF GAS APPLIANCES

The Group sells cooking stoves, water boilers, heaters and stored-value card meters besides providing gas connections. During the year, the Group sold a total of 50,927 cooking stoves, 10,145 water boilers and 6,640 heaters. Most of the meters produced were used by the Group in connection business.

The production capacity of the stored-value card meter factory of the Group reached 500,000 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 has dropped by 30%, and the connection costs of the Group has been substantially lowered. Besides, among the stored-value card meters sold in 2003, 8,943 were sold to other gas distributors, meaning that 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 46.8% in 2002 to 42.7% in 2003, and net profit margin decreased from 23.5% in last year to 20.9% this year. The main reason for the decreases in both gross profit margin and net profit margin was the sale of large amount of LPG during the year. As LPG will be replaced by natural gas gradually and the commencement of W-E Project will facilitate large sales volume of natural gas, the Group expects that the proportion of revenue from natural gas sales will have stable growth, and the gross and net profit margins as a whole will remain around the present level.

&gt;09:53pm

&gt;23:49pm

#### ADVANCED MANAGEMENT SYSTEM

The Group recognises that safe and efficient operation management is the key in gas industry. Xinao Gas has maintained excellent safety track record for the past 11 years of operations. This is achieved 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.

To enhance the standard of operational management and the efficiency of service, during the year, the Group's subsidiary Langfang Xinao Gas Company Limited ("Langfang Xinao") took the lead to use information technology systems by connecting the gas sale system, the call centre, the Geographic Information System and the Supervisory Control and Data Acquisition System. These advanced management systems help to enhance further the Group's operational management. The experience of Langfang Xinao will pave the way for the full implementation of information technology systems in the Group next year.

As in last year, we continued to collect useful opinions on pipeline installation within buildings, pipeline network construction and after-sales services from the customers by organising customer opinion campaign. Because of the continuous efforts of the Group, many of the Group's subsidiaries were awarded Advanced Unit with Safe Management during the year, and Qingdao Xinao Gas Company Limited, the Group's subsidiary in Qingdao, was awarded "Advanced Unit with Quality Management" of the year by the local government.

#### OUTSTANDING MANAGEMENT

Because of the excellent management of the management team, the Company continued to obtain many awards from various prominent international financial magazines during the year:

"The 200 Best Small Companies" by *Forbes Global* for three consecutive years;  
the "Best Small Cap Company (China)" by *AsiaMoney* for three consecutive years;  
the "Chinese Business 500" by *Yazhou Zhoukan* for three consecutive years;  
the "Top 20 Chinese Enterprises of Revenue Growth" by *Yazhou Zhoukan* for two consecutive years;  
the "Top 20 Chinese Enterprises of Assets Growth" by *Yazhou Zhoukan* for the first time; and  
the "Overall Best Managed Company (China)" by *AsiaMoney* again this year after getting this award in 2001.

The above awards, voted by international institutional investors and analysts, prove that Xinao Gas is highly regarded by investors for its high management quality and transparency. It was not easy to obtain such achievements, but the Group's management will endeavour to maintain our outstanding performance.

#### CUSTOMER SERVICE

Quality customer service is the key for maintaining good and long term relations between the Company and customers. The Group is well aware of this and has devoted efforts to maintain quality service of high efficiency and safety standards. Because of our quality service, the Group's subsidiaries have won recognition and credit from local customers as well as government authorities in the cities they operate and become the model for other public utilities to follow. The best evidence is that many of the project companies have been awarded "Unit offering the highest satisfaction to customers" by local consumer councils during the year. Apart from the Group's investment ability and efficient and safe operational management, quality service has also become Xinao Gas' major competitive advantage in competing for new projects.



## MANAGEMENT DISCUSSION AND ANALYSIS

In 2003, Bengbu Xinao, Huaian Xinao, Xinxiang Xinao and Shijiazhuang Xinao Gas Company Limited followed the footsteps of Langfang Xinao, Liaocheng Xinao Gas Company Limited and Huludao Xinao Gas Company Limited to launch the "95158" national 24-hour hotline. Our customers can simply dial 95158 to access their local 24-hour customer service centre and communicate with us conveniently. In case of emergency, we uphold our promise to arrive at the site within 20 minutes to carry out repair work. Our emergency-repair vehicles are approved by the local governments to be equipped with sirens similar to those on police cars, so that we will be able to arrive at the site immediately in any emergency.

In addition, the Group's subsidiaries followed the Group's unified requirements: they issued leaflets of "Gas Usage Safety Standards" to our customers and conducted safety checks twice a year on pipeline networks and customers' gas appliances. These measures not only prevented potential safety problems and embodied the principle of "prevention is always better than cure," but also helped to enhance relationship between the Group and the customers. The Group's safety policies guaranteed that customers would not be affected by pipeline network problems when using natural gas, and thus increased the trust of our customers.

### HUMAN RESOURCES

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

Every year, we recruit high-calibre undergraduates from renowned universities all over the PRC as well as experienced professionals in the industry or from overseas according to our development needs. All new staff will be given internal training and be deployed to different departments and subsidiaries 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 also encourages staff to have lifelong learning. We have sponsored some employees to study for MBA or to attend other related technical courses in renowned universities, so as to enhance their competence, technical skills and quality. The introduction of the gas safety training system from the UK by the Group during the year will also improve the professionalism and occupational knowledge of the staff and facilitate them to provide better service.

The Group also frequently invites university professors and management experts to give in-house training courses to ensure our staff can work with practical theory. Work reviews and assessments with staff are also held regularly to rectify any problems at an early stage. Forums, mailbox to the general manager and staff representative meetings provide other platforms for staff to communicate with the management, so that the Group can make appropriate adjustments and understand the frontline problems.

In addition, in order to have accurate assessment of staff performance and enhance the Group's business, during the year, the Group cooperated with the renowned Beijing H&J Vanguard Management Consulting Company Limited for a human resources project focusing on promoting in the subsidiaries a recruitment standard qualification system, a balanced scorecard system for assessment and a salary points system. The implementation of the project has facilitated the Group to increase its business performance.

Furthermore, the Company regularly invites family members of the employees to attend various functions, such as seminars or dinner parties, and give consolation to employees who are sick, getting married, etc., so as to strengthen communications and affections between staff and the Company, and to enhance the sense of belonging of staff towards the Group.

As at 31 December 2003, the Group had 6,184 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 2003, the Group's cash on hand was RMB487,129,000 (2002: 631,536,000), and its total bank and other borrowings amounted to RMB1,111,926,000 (2002: 467,428,000). Its net gearing ratio, i.e. the ratio of net debt to equity, was 54.9% (2002: zero). The reason for the increase of borrowings of the Group was that the Group acquired not just assets, but also bank and other borrowings from the PRC JV partners, when acquiring large scale projects, and these assets and liabilities were injected into the joint ventures. However, the assets and liabilities ratios of these large scale projects are healthy, and they usually have high revenue and earning capacity. Therefore, the increase in liabilities is normal during acquisition process. When the gas penetration rates increase in these project companies, their liabilities will decrease gradually.

During the year, since the annual interest rate continued to fall and stayed at low levels, Xinao Gas, in order to cope with the Group's future development, obtained a three-year, unsecured syndicated loan of US\$45 million in August 2003. Also, the Company had a share placement with net proceeds of HK\$456,000,000 in February 2004. It is expected that the loan and funds, when aggregated with the Group's internal resources and bank borrowings, are sufficient to finance the future operational and capital expenditure.

### BORROWINGS STRUCTURE

As at 31 December 2003, the Group's total bank and other borrowings amounted to RMB1,111,926,000 (2002: RMB467,428,000), including a three-year unsecured syndicated loan of US\$30 million signed on September 2002 (equivalent to RMB248,040,000) and another three-year unsecured syndicated loan of US\$45 million signed on August 2003 (equivalent to RMB372,060,000), which bear interest at floating rates. The remaining bank and other borrowings are denominated in Renminbi granted at fixed interest rates ranging between 4.5% and 5.5% by local banks and other companies in the PRC to the project companies as their working capital and operational expenditure. Except for the loan amount of RMB33,173,000

that has to be secured by assets with the net asset value of approximately RMB79,972,000, all of the other loans are unsecured. Short-term loans amounted to RMB541,390,000 while the remaining were long-term loans falling due after more than a 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 exposure except for the two three-year syndicated loans of total amount of US\$75,000,000. The Group had signed interest rate and exchange rate swap agreements for the syndication loans of US\$75,000,000 to fix the interest rates and exchange rates. As the interest rates remained low at the moment, the Group's management believed that changing the floating interest rates into fixed interest rates at the present level would be beneficial to the Company.

### CONTINGENT LIABILITIES

During the year, the Group had released guarantee to a bank in respect of banking facilities granted to a third party to the extent of RMB39,500,000. As at 31 December 2003, the Group did not have any contingent liabilities (2002: RMB39,500,000).