

Report of the Directors

Dear shareholders,

The directors present their first report and the audited financial statements of the Company and the Group for the year ended 31 December 2005.

Principal activities

The principal activities of the Company are the design, manufacture and sale of products and provision of related services in the power equipment, electromechanical equipment, transportation equipment and environmental protection industries. Details of the principal activities of the principal subsidiaries are set out in note 18 to the financial statements. There were no significant changes in the nature of the Group's principal activities during the year.

Results and dividends

The Group's profit for the year ended 31 December 2005 and the state of affairs of the Company and the Group at that date are set out in the financial statements on pages 45 to 145.

The directors recommend the payment of a final dividend of RMB4.1 cent per ordinary share in respect of the year to shareholders on the register of members on 16 June 2006. This recommendation has been incorporated in the financial statements as an allocation of retained profits within the equity section of the balance sheet.

Use of proceeds from the Company's initial public offering

The proceeds from the Company's issue of new shares at the time of its listing on The Stock Exchange of Hong Kong Limited (the "Stock Exchange") in April 2005, after deduction of related issuance expenses, amounted to approximately RMB4,678 million. The proceeds of RMB1,818 million were applied during the year ended 31 December 2005 in accordance with the proposed applications set out in the Company's listing prospectus, as follows:

* Approximately RMB661 million was used in the power equipment division, comprising investments in technology improvement and capacity expansion of pro-

duction facilities, new joint ventures and development of new products;

* Approximately RMB640 million was used in the electromechanical equipment division, comprising investments in technology improvement of production facilities and development of new products;

* Approximately RMB68 million was used in the transportation equipment division, comprising investments in production expansion and product design capability enhancement;

* Approximately RMB129 million was used in the environmental systems division, comprising investment in solar cells business and sewage water treatment business; and

* Approximately RMB320 million was applied as additional working capital of the Group.

Summary financial information

A summary of the published results and assets, liabilities and minority interests of the Group for the last four financial years, as extracted from the audited financial statements and restated/reclassified as appropriate, is set out on page 3. This summary does not form part of the audited financial statements.

Property, plant and equipment

Details of movements in the property, plant and equipment of the Company and the Group during the year are set out in note 14 to the financial statements.

Share capital

Details of movements in the Company's share capital during the year are set out in note 40 to the financial statements.

Pre-emptive rights

There are no provisions for pre-emptive rights under the Company's bye-laws/articles of association or the laws of the People's Republic of China ("the PRC") which would oblige the Company to offer new shares on a pro rata basis to existing shareholders.

Purchase, redemption or sale of listed securities of the Company

Neither the Company, nor any of its subsidiaries purchased, redeemed or sold any of the Company's listed securities during the year.

Reserves

Details of movements in the reserves of the Company and the Group during the year are set out in note 41 (b) to the financial statements and in the consolidated statement of changes in equity, respectively.

Distributable reserves

At 31 December 2005, the Company's reserves available for distribution, calculated in accordance with the relevant regulations, amounted to RMB1,012,364,000, of which RMB487,558,000 has been proposed as a final dividend for the year. In addition, the Company's share premium account, in the amount of RMB1,975,387,000, may be distributed in the form of fully paid bonus shares.

The amount for which the Company can legally distribute by way of a dividend is determined based on the lower of the retained profits determined in accordance with PRC General Accepted Accounting Principles ("PRC GAAP") and Hong Kong Financial Reporting Standards ("HKFRS").

Major customers and suppliers

In the year under review, sales to the Group's five largest customers accounted for less than 30% of the total sales for the year. Purchases from the Group's five largest suppliers also accounted for less than 30% of the total purchases for the year.

Directors

Please refer to page 22 for list of directors of the Company during the year.

Subsequent to the balance sheet date, on 29 January 2006, Mr. Cheng Xinhua resigned as a director of the Company. On 27 March 2006, Mr. Lin Haitao was appointed as a director of the Company.

The non-executive directors and independent non-executive directors are appointed for a period of three years.

The Company has received annual confirmations of independence from Mr. Yao Fusheng, Mr. Cheung Wai Bun and Mr. Lei Huai Chin, and as at the date of this report still considers them to be independent.

Directors' biographies

Biographical details of the directors of the Company are set out on pages 22 to 25 of the annual report.

Directors' service contracts

Each of the executive directors of the Company has entered into a service contract with the Company on 28 March 2005. According to the terms of the service contracts, each of the executive directors agreed to be appointed as the Company's executive directors until 28 September 2007. These contracts are renewable in accordance with the Company's articles of association and related listing rules and terminable at the option of the Company and the executive directors by giving three months' notice in writing or according to the terms of the contract prior to the expiry of the contract.

Apart from the foregoing, no director has a service contract with the Company which is not determinable by the Company within one year without payment of compensation, other than statutory compensation.

Directors' remuneration

The directors' fees are subject to shareholders' approval at general meetings. Other emoluments are determined by the Company's board of directors with reference to directors' duties, responsibilities and performance and the results of the Group.

Directors' and supervisors' interests in contracts

No director and supervisor had a material interest, either directly or indirectly, in any contract of significance to the business of the Group to which the Company, its holding company, or any of its subsidiaries or fellow subsidiaries was a party during the year.

Management contracts

Pursuant to an agreement dated 28 March 2005 between the Company and its holding company, Shanghai Electric (Group) Corporation ("SE Corporation"), SE Corporation (either by itself or through its subsidiaries) provides various kinds of auxiliary services including labour secondment, property management, management of research centres and projects, water and electricity supply, auxiliary support, training and education, facility, security and maintenance services to the Company. The term of the agreement is three years, renewable at the option of the Company for another term of three years by giving three months' notice in writing prior to the expiry of the term. During the year, the Company paid a management service fee of RMB12,223,000 under this agreement.

Directors' interests and short positions in shares and underlying shares

Long positions in ordinary shares of the Company:

Name of director	Note	Number of shares held, capacity and nature of interest				Total	Percentage of the Company's issued share capital
		Directly beneficially owned	Through spouse or minor children	Through controlled corporation	Beneficiary of a trust		
Mr. Zhang Rongkun	(a)	-	-	581,261,222	-	581,261,222	4.89

Note:

- (a) The 968,768,703 shares of the Company are held by Fuxi Investment Holdings Co., Ltd., a substantial shareholder of the Company, of which 60% are beneficially owned by Mr. Zhang Rongkun.

Save as disclosed above, as at 31 December 2005, none of the directors had registered an interest or short position in the shares or underlying shares of the Company or any of its associated corporations that was required to be recorded pursuant to Section 352 of the SFO, or as otherwise notified to the Company and the Stock Exchange pursuant to the Model Code for Securities Transactions by Directors of Listed Issuers.

Directors' rights to acquire shares and debentures

At no time during the year were rights to acquire benefits by means of the acquisition of shares in or debentures of the Company granted to any director or their respective spouse or minor children, or were any such rights exercised by them; or was the Company, its holding company, or any of its subsidiaries or fellow subsidiaries a party to any arrangement to enable the directors to acquire such rights in any other body corporate.

Contract of significance

During the year, the Company has entered into various contracts of significance with SE Corporation. Further details of the transactions are set out in the section "Connected transactions and continuing connected transactions" below.

Substantial shareholders' and other persons' interests in shares and underlying shares

At 31 December 2005, the following interests of 5% or more of the issued share capital of the Company were recorded in the register of interests required to be kept by the Company pursuant to Section 336 of the SFO:

Long positions:

Name	Shares type	Capacity and nature of interest	Number of ordinary shares held	Percentage of the Company's issued share capital
SE Corporation	Domestic	Directly beneficially owned	6,134,387,334	51.58
Fuxi Investment Holdings Co., Ltd.	Domestic	Directly beneficially owned	968,768,703	8.15
Guangdong Zhujiang Investment Co., Ltd.	Domestic	Directly beneficially owned	917,778,942	7.72

Save as disclosed above, as at 31 December 2005, no person had registered an interest or short position in the shares or underlying shares of the Company that was required to be recorded pursuant to Section 336 of the SFO.

Connected transactions and continuing connected transactions

During the year, the Company and the Group had the following connected and continuing connected transactions, certain details of which are disclosed in compliance with the requirements of Chapter 14A of the Listing Rules.

Connected transactions

Shanghai Electric Group Printing & Packaging Machinery Co., Ltd., a subsidiary of Shanghai Mechanical & Electrical Industry Co., Ltd. ("Shanghai Mechanical"), a 47.28%-owned subsidiary of the Company, and Shanghai Printing & Packaging Machinery Co., Ltd. ("Shanghai Printing"), a subsidiary of the Company's ultimate holding company, entered into an asset transfer agreement on 14 June 2005 to purchase the property from Shanghai Printing for a cash consideration of RMB33.9 million.

Shanghai Diesel Engine Co., Ltd., a 50.32%-owned subsidiary of the Company, and SE Corporation entered into a property transfer agreement on 17 November 2005 to dispose of a property to SE Corporation for a cash consideration of RMB32.9 million.

The Company, through two of its subsidiaries, Shanghai Mechanical and Shanghai Welding Equipment Co., Ltd. ("Shanghai Welding"), and Shanghai Electric Group Asset Operation Company Ltd. ("Shanghai Asset Operation"), a subsidiary of SE Corporation, entered into property transfer agreements on 17 November 2005 to dispose of two properties to Shanghai Asset Operation for a total cash consideration of RMB127.4 million. Pursuant to the agreement, Shanghai Mechanical and Shanghai Welding will hand over the properties to Shanghai Asset Operation by 31 December 2007. As such, the transaction was not completed as at 31 December 2005.

During the year ended 31 December 2005, the Group purchased from Siemens Aktiengesellschaft equipment and components with a total amount of RMB725.1 million.

Continuing connected transactions

Framework Land Lease Agreement

On 1 January 2005, the Company has entered into a framework land lease agreement with SE Corporation, pursuant to which, SE Corporation agrees to lease (either by itself or through its subsidiaries), parcels of land with total area of approximately 2,110,954 square metres to the Group. The term of each lease is either 20 years or the remaining term of operation of the joint venture that is the tenant of the relevant premises in the event that the remaining term of operation of the relevant joint venture is less than 20 years. The rental payment due to SE Corporation is RMB29.95 million per year for the first three years of the agreement and is to be reviewed every three years, taking into account market conditions and should not be lower than the rent applicable to a third party tenant.

In the year ended 31 December 2005, the rental payment payable to SE Corporation was RMB29.95 million.

Framework Guarantee Agreement

After 28 April 2005, being the listing date of the Company, Shanghai Electric Finance Co., Ltd., a subsidiary of the Company, no longer provided any financial services to SE Corporation and its connected persons (the "Parent Group") except for the guarantees provided to the Parent Group prior to 30 January 2005 and which are still subsisting as at 28 April 2005 (the "Existing Guarantees"). Shanghai Electric Finance Co., Ltd. entered into a framework guarantee agreement on 28 March 2005 with SE Corporation to set out the terms on which Shanghai Electric Finance Co., Ltd. will continue its role as guarantor in relation to the Existing Guarantees. Pursuant to the framework guarantee agreement:

- SE Corporation will indemnify Shanghai Electric Finance Co., Ltd. against all losses it may suffer under the Existing Guarantees; and
- Shanghai Electric Finance Co., Ltd. will no longer provide any new guarantees in favour of the Parent Group.

The term of the framework guarantee agreement will lapse on the date that the terms of all of the Existing Guarantees have expired.

As at 31 December 2005, the guarantees provided to the Parent Group were RMB171.4 million.

Framework Sale Agreement

On 28 March 2005, the Company entered into a framework sale agreement with SE Corporation, pursuant to which, the Group has agreed to sell, on a non-exclusive basis, certain products from its various business divisions, both finished and semi-finished, to the Parent Group. The framework sale agreement is entered into in the ordinary course of its business and is on normal commercial terms. The payments due to the Group from the Parent Group under the framework sale agreement shall be:

- such prices as may be stipulated by the PRC Government (if any); and if there are no such stipulated prices,
- prices not lower than any pricing guidelines or pricing recommendations set by the PRC Government (if any); and if there are no such pricing guidelines or recommendations,
- prices not lower than market price; and if there is no market price for a particular product,
- an agreed price consisting of the actual or reasonable cost incurred by the Group in supplying the product plus a reasonable profit.

The term of the framework sale agreement is three years, renewable at the option of the Company for another term of three years by giving three months' notice in writing prior to the expiry of the term.

In the year ended 31 December 2005, the Group's sale to the Parent Group amounted to RMB325.6 million.

Framework Purchase Agreement

The Company has entered into a framework purchase agreement dated 28 March 2005 with SE Corporation, pursuant to which, the Group has agreed to purchase (on a non-exclusive basis) raw materials and component parts from the Parent Group and the Parent Group has agreed to supply (on a non-exclusive basis) such raw materials and component parts to the Group. The payments due from the Group under the framework purchase agreement shall be:

- such prices as may be stipulated by the PRC Government (if any); and if there are no such stipulated prices,
- prices not exceeding any pricing guidelines or pricing recommendations set by the PRC Government (if any); and if there are no such pricing guidelines or recommendations,
- prices not exceeding market prices; and if there is no market price for a particular product,
- an agreed price consisting of the actual or reasonable cost incurred by the Parent Group in supplying the product plus a reasonable profit.

The term of the framework purchase agreement is three years, renewable at the option of the Company for another term of three years by giving three months' notice in writing prior to the expiry of the term.

In the year ended 31 December 2005, the Group's purchases from the Parent Group amounted to RMB845 million.

The Stock Exchange has granted the Company a waiver from compliance with Chapter 14A of the Listing Rules for the aforementioned continuing connected transactions till 31 December 2007 pursuant to its letter dated 12 April 2005.

The independent non-executive directors of the Company have reviewed the continuing connected transactions set out above and in note 47 to the financial statements and have confirmed that these continuing connected transactions were entered into (i) in the ordinary and usual course of business of the Group; (ii) on normal commer-

cial terms or on terms no less favourable to the Group than terms available to or from independent third parties; and (iii) in accordance with the relevant agreements governing them on terms that are fair and reasonable and in the interests of the shareholders of the Company as a whole.

Sufficiency of public float

Based on information that is publicly available to the Company and within the knowledge of the directors, 23.75% of the Company's total issued share capital was held by the public as at the date of this report. The Stock Exchange agreed to exercise its discretion under Rule 8.08(1)(d) of the Listing Rules to allow the minimum prescribed percentage of the Company's total issued share capital which at all times must be held by the public to be 23.75%.

Post balance sheet events

Details of the significant post balance sheet events of the Group are set out in note 49 to the financial statements.

Auditors

Ernst & Young retire and a resolution for their reappointment as auditors of the Company will be proposed at the forthcoming annual general meeting.

For and on behalf of the board

Wang Chengming
Chairman

Shanghai, PRC
25 April 2006