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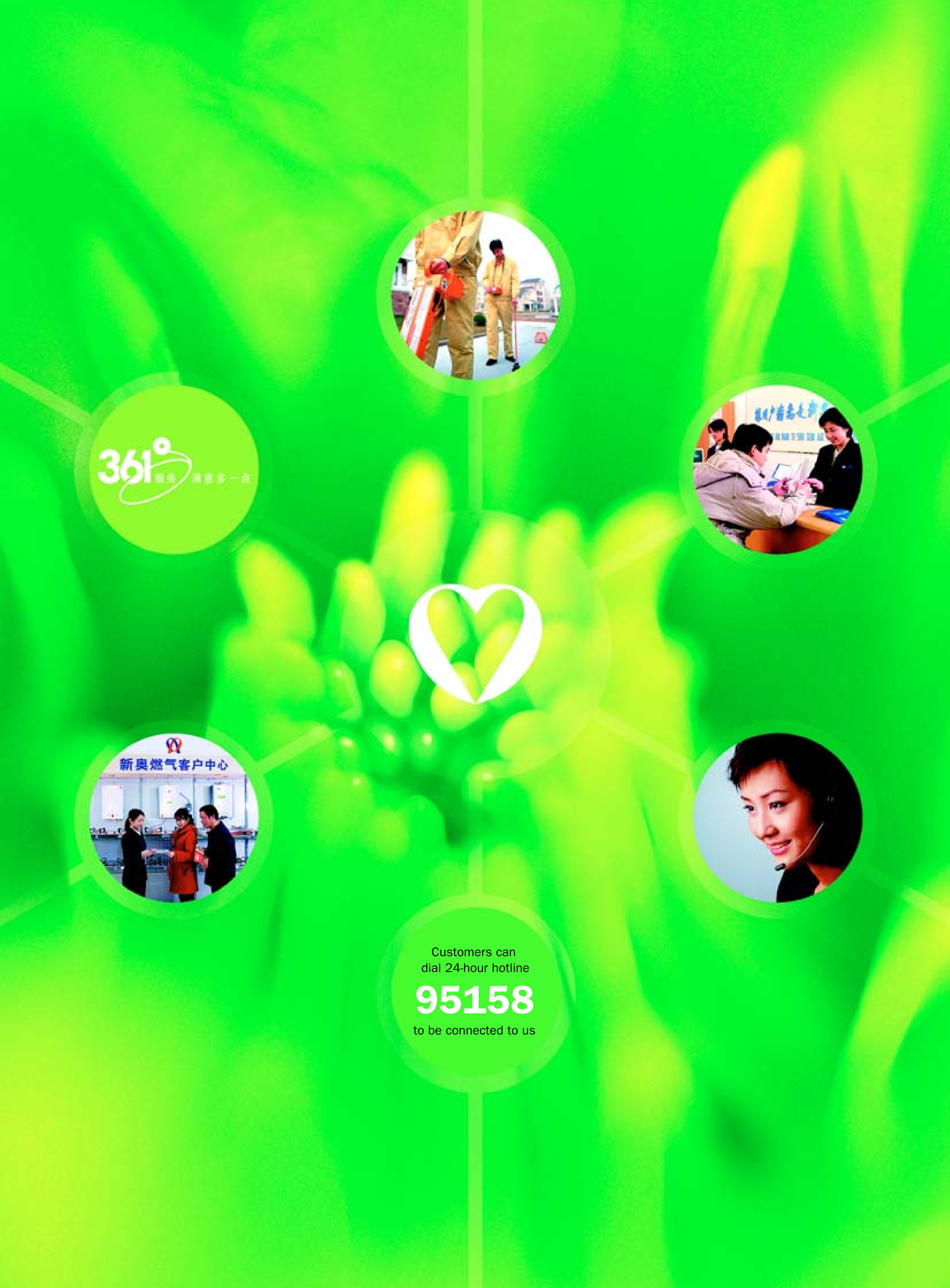
'Care'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Xinao Gas will continue to pursue innovation and excellence in its unrelenting efforts to become a first class clean energy distributor in the PRC with international recognition.

Industry Review

Energy consumption pattern in PRC

The use of clean energy and development of natural gas industry is an essential trend under the continuous economic development and energy structural adjustment in the People's Republic of China (the "PRC"). Natural gas is deployed by the PRC government as a major tool for energy structure enhancement and environmental protection. In 2004, the PRC government established a new energy strategy, which required a raise of natural gas ratio in energy consumption structure to 7% by 2010. In the future, the PRC government will actively invest in natural gas infrastructure construction, including 50,000 km natural gas pipeline, tens of million tons of liquefied natural gas ("LNG") import terminals and million tons of LNG transportation capacity. About 10 LNG import terminals will be built at the Bohai area, the Yangtze River Delta, and the Pearl River Delta and the capacity of the LNG import facilities will reach 50 million tons. It is expected that by 2020, natural gas consumption in the PRC will reach 220 billion cubic meters. The development of the PRC natural gas industry has come into full swing.

Whilst the annual growth rate for petroleum output in the PRC is only 2%, the natural gas output is growing at the high speed of about 20% per annum, and it is estimated that the natural gas output for 2007 is about 72 billion cubic meters. It is forecasted that natural gas supply in the PRC will have planned and comprehensive trends: firstly, West-East gas transfer, high-quality natural gas is transferred from the west to coastal areas in the east (its current annual transmission capacity is 12 billion cubic meters, and such capacity is expected to increase further in the future); secondly, North-South gas transfer, natural gas from the north and even Russia is transferred to the Bohai area, the Yangtze River Delta and the Pearl River Delta; thirdly, offshore gas to land, on the one hand, natural gas produced by the PRC in offshore areas is transferred to coastal areas (it is estimated that the annual offshore gas capacity of the South China Sea, the Bohai Sea and the East China Sea will reach 10 billion cubic meters), and on the other hand, imported LNG is supplied to coastal areas by precedence (the Guangdong LNG Terminal has commenced operation, whilst the LNG projects in Fujian Province, Zhejiang Province and Shanghai Municipality have commenced development and other coastal provinces and cities are also making plans, and together with offshore gas to land, it will form a coastal natural gas supply network by 2020); nearby supply, areas surrounding resource pools utilise natural gas nearby; fourthly, diversified gas sources, to increase natural gas reserve by advanced exploration techniques and to raise import volume of natural gas through international cooperation.

During the 11th Five-Year Plan period, there is more rapid development on clean energy and a continuous rapid growth on natural gas, and it is expected that the coal-based clean energy industry will usher in a new development area full of vitality. The fast-growing natural gas market will deliver major opportunities for the Group. The Group will make a correct assessment of the situation and seize the opportunities to continue in contributing to environmental protection of the PRC and creating value for shareholders in the long run.

PRC policies on city piped natural gas market

During the year, the PRC government continues to encourage the development of the non-state-owned economy. Since the issue of "Opinions on encouraging the development of non-state-owned economy" by the State Council of the PRC at the beginning of 2005, the market liberalisation of energy distribution, in particular city piped natural gas in the PRC has been maturing and getting enhanced.

According to the 11th Five-Year Plan, the PRC government will strengthen the development of basic industries and infrastructures, emphasise both oil and gas, reinforce the exploration and exploitation of oil and gas, extend the cooperation with other countries, increase strategic oil reserve capacity, develop oil substitutes steadily, tighten controls on environmental pollution and ensure protection to the natural ecosystem. During the year, various government departments, including the National Development and Reform Commission, the State Energy Bureau and the State Administration of Taxation, set forth various policies for more stringent measures on pollution and encouraging the development and utilisation of clean energy and sustainable utilisation of existing resources, including natural gas, vehicles using clean fuels in the city, coal-based clean fuels. The current PRC government policies strongly encourage and support the development of piped gas market.

Business Review

The principal businesses of the Group are the construction of gas pipelines, the sale of piped gas, operation of natural gas refuelling stations, the sale of bottled liquefied petroleum gas ("LPG") and the sale of gas appliances.

Construction of gas pipelines

During the year, following the Group's strategic adjustments, one of the Group's main focuses for 2006 and the coming few years is to boost gas penetration rate continuously.

As of 31 December 2006, the Group's gas penetration rate was 18.9% which is higher than 2005. With the rapid growth in the number of connected residential households and commercial and industrial ("C/I") customers in the piped gas projects as well as the vehicle gas refuelling stations ("refuelling station"), the Group's natural gas sales volume also increased remarkably. As the increase of gas sales is faster than growth in connection fee, in spite of the strong growth in connection fees, the Group expects that the proportion of gas sales to total turnover will increase, and gas sales will take over as the major source of revenue and profit.

Residential customers

During the year, the Group followed its development strategy and continued to devote lots of efforts to connecting more residential households in the project cities. The Group's high-level piped gas business is a natural monopoly in nature. The main connection target of the Group will continue to be the residential households in new and existing buildings in the area covered by our pipeline network.

Flats connected to piped natural gas have become popular and are preferred by new home buyers. Also, there has been increased consumer awareness of the advantages of cleanliness, economy and convenience in natural gas over other main fuels used in the cities. These boosted the connection business of the Group and lowered the Group's costs for developing new customers.

During the year, the Group made natural gas connections for 451,072 new residential households, 34.8% more than last year. The average connection fee paid by households was RMB2,784. The substantial growth in connection proves once again the Group's ability to increase gas penetration rates in the project cities.

As at the end of 2006, the Group had accumulated 2,069,783 natural gas residential customers, and the natural gas penetration rate was 15.9%. If the other piped gas residential customers were also included, the Group had accumulated 2,458,735 piped gas residential customers, and the piped gas penetration rate was 18.9%. As the population coverage in 2006 grew by 6,686,000, if this factor is set aside, the Group's penetration rate against last year's projects has increased to 22.7%. According to the industry experience, penetration rate of piped gas can reach above 80% ultimately. In this connection, the Group still has a large pool of potential customers for new connections.

Commercial/industrial customers

During the year, the international oil price continued to soar, and the supply of coal, electricity and oil in the PRC continued to be tight. As the local governments in the PRC have implemented more stringent measures for environmental protection and put more efforts in controlling industrial pollution, more and more cities restrict the use of coal as primary energy source and require new commercial or industrial projects to use clean energy and change some of the existing coal-burning furnaces into natural gas-burning furnaces, which expedite natural gas connection for C/I customers. Apart from government support, there will be more and more natural gas sources available, it facilitates the Group to connect more large volume C/I customers.

Furthermore, the Group, together with International Finance Corporation (the private sector arm of the World Bank Group) ("IFC") and Industrial Bank Co., Limited ("Industrial Bank"), has launched the "China Utility-Based Energy Efficiency Finance Program" during the year to promote the use of clean energy among C/I customers. The program allows IFC to provide financial guarantee to Industrial Bank, and in turn Industrial Bank will have confidence to offer loans to the C/I customers of Xinao Gas. The C/I customers may use the loans for paying connection fees, gas engineering fees and purchasing gas related equipment. It is IFC's first program of the kind in Asia and attracts a lot of attention from the World Bank and environmental funds in the world. The Group has decided to have 12 project companies to be the first batch participating in the program.

During the year, the Group provided natural gas connections for 1,493 new C/I customers (connected to gas appliances of a total installed designed daily capacity of 1,481,611 cubic meters), 41.7% more over last year. The average connection fee was RMB281 per cubic meter.

As at the end of 2006, the Group had accumulated 5,778 natural gas C/I customers (connected to gas appliances of a total installed designed daily capacity of 4,372,540 cubic meters). If the other piped gas users were also included, the Group had accumulated 6,290 piped gas C/I customers (connected to gas appliances of a total installed designed daily capacity of 5,023,652 cubic meters).

New projects

The Group has started its strategic adjustment in 2005 to have sustainable development in the long run. The Group has shifted the emphasis from acquiring a large number of new gas projects to boosting gas penetration rates in our existing projects, developing refuelling station business and exploring channels to provide bottled LPG and other clean energy alternatives to the sub-urban areas around the existing projects, which will increase long term natural gas sales. As there will be more piped natural gas sources in the future, the Group will continue to obtain some quality projects in large scale or projects that have strategic significance for the Group. During the year, the Group obtained five projects, namely, Jinjiang, Shishi, Nanan and Huian in Fujian Province, and Laian in Anhui Province. The Group's number of projects increased to 64 this year from 59 last year, and the connectable population grew by 20.6% to 39,073,000 (approximately 13,024,000 households) by the end of 2006 from 32,387,000 (approximately 10,796,000 households) last year. This further strengthens the Group's long term revenue source and fortifies the Group's leading role in the industry. Among the newly acquired projects, the four projects in Fujian Province were new projects obtained in Fujian Province following Quanzhou in 2005. They are also closed to the Quanzhou Project. Laian Project in Anhui is also close to the Group's existing projects in Bengbu and Chuzhou, and like Fengyang Project last year, it is also a successful example of the Group's development model, which is the expansion from core project to periphery cities and towns.

Sale of piped gas

During the year, the Group's total sales volume of piped gas was 1,327,745,000 cubic meters, 1.8 times more than last year, and 299,806,000 cubic meters and 1,027,939,000 cubic meters piped gas was sold to residential households and C/I customers respectively, representing increases of 51% and 2.8 times respectively over last year. The sales volume of gas to C/I customers made up 77.4% of the total volume of gas sales, showing that the Group has large volume users to support the large gas sale. It is expected that the proportion of sales volume to C/I customers will continue to grow and allow the Group to enjoy economy of scale in gas sale and stable long term revenue.

With even more plentiful gas sources and the growth in various customers of the Group, gas sales revenue has become the major revenue source, and its proportion in future revenue will continue to get larger. With more and more maturing projects, gas sales will have increasingly higher contribution to the Group's profit. Such enhanced revenue structure will bring in stable long term cash flow to the Group. As the gas sales volume for C/I customers is much higher than residential households, the Group will continue to develop the markets of both residential households and C/I customers.

Compressed natural gas ("CNG") vehicle gas refuelling station

Since vehicle emission is now a major source of pollution in the large cities in the PRC, the PRC governments promote the policies on converting vehicles to using clean energy. This will further accelerate the refuelling station business. Besides, the price of natural gas is cheaper in comparison with the vehicle-used gasoline in the PRC. Therefore, through developing refuelling station business, the Group can raise the distribution volume and revenue on clean energy in future on top of contributing to the environmental protection business. In this regard, refuelling station business is one of the Group's business focuses in this year and the future, and it is expected that the revenue from refuelling station business will become one of the Group's major revenue sources in the long run. During the year, the Group has collaborated with Shanghai Communication University and Shanghai Tongji University for a research on the development and application of alternative vehicle-used gas, such as dimethyl ether ("DME") and hydrogen.

Apart from converting 5,726 taxis and 350 buses into vehicles using CNG in existing project cities, the Group has also keenly developed refuelling station business in other areas. During the year, the Group has obtained approval from local governments of Xingtai City and Handan City of Hebei Province, Nantong City and Zhenjiang City of Jiangsu Province, and Xinzhou City of Shanxi Province to build 43 CNG refuelling stations. The Group also established Nantong Xinao Vehicle Gas Development Company Limited and Zhenjiang Xinao Vehicle Gas Development Company Limited in Nantong City and Zhenjiang City respectively, which would specialise in the business of vehicle gas sales.

At the same time, the Group has successfully acquired Shanghai Jiuhuan Automobile Liquid Gas Development Joint-Stock Limited Company and Shanghai Jiuhuan Automobile Natural Gas Development Company Limited. These two companies separately own 32 refuelling stations in aggregate, comprising about half of the refuelling stations and the vehicle gas sales volume in Shanghai. The successful acquisition of these companies has not only increased the number of refuelling stations immensely, but also led the Group's way into the Shanghai market, providing a foundation for the crystallization of strategic target in future.

As at year end, the Group has obtained government approval of 212 refuelling stations in aggregate, There are 57 refuelling stations constructed/acquired and in operation.

Gas source

Security of natural gas source is the key factor for the development of the Group in the long run. Apart from signing take-or-pay contracts with suppliers at West-East Pipelines, Zhongxian-Wuhan Pipelines and Guangdong LNG Terminal, the Group has also continued the development of alternative energy source for natural gas. During the year, the Group has invested in Erdos, Inner Mongolia together with Xinao Group Company Limited and Xinneng Investment Group Limited to utilise the rich coal resources and clean production technique for the production of DME, which is a clean fuel and can be used as direct substitute for LPG and diesel. It is expected that phase one of this project will come into operation in 2009 with an annual production capacity of 400,000 tons of DME. Moreover, the Group has collaborated with renowned tertiary institutions including Shanghai Communication University on research about the application technology for substituting natural gas with DME. On top of promoting the use of DME among residential customers and C/I customers, there are also active promotion on vehicle used fuel.

In addition, the construction of the LNG project in Weizhou Island, Beihai, Guangxi was completed, and phase one of the project has come into operation. It is the fourth LNG plant in the PRC. The plant will mainly supply LNG to the Group's projects in the south to meet the gas demand of the projects and further reduce the purchase cost of gas.

Phase one of Guangdong LNG project, which is the first import LNG project in PRC, has come into operation on 28 June 2006. A take-or-pay contract with a term of 25 years has been signed in the Phase one of the project with the upstream supplier in Australia. The Dongguang Project makes up an important part of the Guangdong LNG project. In early August 2006, upstream piped natural gas supply commenced for the Group's project Dongguan Xinao Gas Company Limited ("Dongguan Xinao"). Supply to customers has come into operatin on 28 September in the same year, providing supportive condition for connection with prosperous C/I customers under Dongguang Xinao project.

With a view to broadening energy purchasing channel and to crystallising the Group's strategic targets of energy distribution, the Group has been actively seeking international purchase of clean energy. The Group has established Xinao Energy Sales Company Limited during the year and obtained the import and export right of natural gas, LPG, methanol, DME and various kinds of gas materials, making the Group the fourth company having the import/export right of natural gas after the PRC's three oil and gas giants, which has paved the way for the Group's international energy trading business.

In 2006, the Group has established the energy distribution system with main channels on road and railway transportation through Xinao Energy Logistics Company Limited. The system sets up a commercial value chain along the line from energy purchase, energy logistics to energy distribution serving end-users. It serves as an effective solution for gas source issue, raises the commercial value of the Group, broadens the source of profit, and further secures gas supply.

At the same time, the Group has invested capital and resources to strengthen the gas supply system and contingency supply system. During the year, additional 58 LNG trucks were purchased, raising the total number of trucks to 170 with a total one-time transmission capacity of 4,086,800 cubic meters. Moreover, on stable gas supply security, the Group is able to get accurate figures on gas stock level and information on demand and supply by using information technology and logistic information system. This raises the normal supply capability and contingency supply capability.

Advanced collection system for gas usage charges

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

Starting from 2004, some of the Group's project companies started to cooperate with local banks for collection of gas usage charges. The widespread network resources of the banks have fostered satisfactory effectiveness in gas usage charges collection. During the year, there is increasing number of enterprises under the Group cooperating with local banks for collection of charges. The Group has benefited from the reduction of the corporate administrative expense whilst the local banks could utilise the Group's customer base for business development, which creates a win-win situation.

Sale of bottled LPG

During the year, the Group sold 58,136 tons of bottled LPG (2005: 45,179 tons), increased by 28.7% over last year. The operating profit of bottled LPG increased from RMB3,960,000 in 2005 to RMB10,769,000 this year.

In association with the Group's strategic adjustment, the Group has fully utilised its corporate branding, the capacity of infrastructure in urban centre and management resources for expanding the construction of distribution channels to the suburban areas. Riding on DME, the clean fuel with costing advantage, the Group has expanded its shares in the energy distribution market. In 2006, the Group has made distribution of LPG as a component of the Group's strategy.

During the year, the Group has joined force with Roland Berger Strategy Consultants Co., Ltd., a consultation company with international reputation, to increase revenue from the suburban and agricultural village market with huge population riding on the technique development of substituting LPG by DME. The project also broadens customers base, crystalises a rational business structure and expedites the realization of clean energy distribution strategy.

Sale of Gas appliances

The Group sells cooking stoves, water boilers, heaters and stored-value card gas meters. The Group produces stored-value card gas meters itself, most of which are used by the Group in its own connection business, which can lower the average cost of gas meters. The Group also sells gas meters to other gas distributors, which generated additional income for the Group.

Gross and net profit margins

In 2006, the Group's overall gross and net profit margins were 14.2% and 35.1% respectively, representing drop of 2.4% and 3.4% in comparison with last year correspondingly. One of the major causes for the drop was the change in the Group's revenue structure. As the Group has been increasing gas penetration rates, the share of piped gas sales revenue has increased drastically from 37.4% last year to 47.8%, whereas the share of connection fee has fallen immensely from 50.2% to 39.9%. Notwithstanding the satisfactory growth of both piped gas sales revenue and connection fee, the higher profit margin of connection fee in comparison with piped gas sales drives the Group's gross and net profit margin to a downward track under the change of revenue structure. Such trend will continue until the revenue structure becomes relatively stable. Yet, this reveals that the Group's revenue structure has been further enhanced through the gradual changes from relying on one-off connection fee to recurring piped gas sales which is stable in long term.

Another reason for the drop of profit margin comes from the adoption of new accounting standard. In particular, the options granted by the Group to the senior management and the convertible bonds issued in 2004 has led to the expenses of RMB57,370,000 and RMB4,392,000 respectively, both amounts were non-cash expenses but recorded as reserves, which reduced the Group's profit directly.

Advanced safety management system

The Group has maintained good record on safe operation and put paramount priority on safe operation always. During the year, the Group drew on the experience from the advanced associates in gas business in United Kingdom ("UK"), enhanced safety management manual, operation management manual and contingency manual, and restructured the technical quality safety department into asset management department and health, safety and environmental management office. Accordingly, an effective monitoring and control system has been established swiftly. The Group set up a safety monitoring expertise team, which would deploy measures such as random checking and sudden visit to strengthen monitoring effectiveness. Other measures including the establishment of safety information briefing channel and timely safety check reporting, conducting seminars on dangerous point recognition for alleviating safety risk. In addition, three enterprises including Dongguan Xinao have established geographical information system.

During the year, the Group continued the development of the gas professional training centre, which was established together with a UK Company, Utilise Training & Development Solutions Limited to conduct trainings and the professional qualification recognitions, with an aim to enhance the professional qualification and expertise of the employees for provision of good services to customers. Riding on the trainings and the professional qualification recognition framework of Levels 1 to 3, the Level 4 has been introduced during the year to further develop outstanding employees, so as to further enhance operational safety level and efficiency. During the year, the training center conducted 20 sessions of training courses, bringing the accumulated number of employees passing Occupational Qualification Examinations ("Examinations") to around 1,800. In 2007, the Group will introduce Level 5 (the highest level) Examinations, as well as the training and qualification recognition to foster the safety technique and quality of employees and ensure safe operation.

Outstanding management

With a view to drawing on the best practical management experience of the corporations in the industry worldwide, in 2005, the Group has joined force with IBM Global Services (China) Company Limited ("IBM") to launch a consultation project on process streamlining and information system management. Under the early stage of process streamlining, the total IT solutions project was commenced officially in June 2006. Four subsidiaries were selected as the trial run units, with project teams comprising experienced employees being set up for project implementation in full swing. The Group was the first enterprise with parallel implementation of the enterprise management software SAP utilities solution, oil and natural gas industry solution and enterprise resource planning. The total IT solutions project was put into practice on 8 January 2007 as scheduled. It is expected that the total IT solutions project will be implemented in full force by 2009.

To ensure effective communication of the Group's strategy and to enhance the ability of strategy execution, the Group instigated a strategic performance management project effectively during the year. The project emphasises development of strategic solution capability among fundamental units, effective communication of the Group's strategy along the organisation structure pyramid, and the establishment of the cycle of strategy-performance-motivation. Under this project, the Group's strategy has been clarified, the review and configuration work for strategy diffusion among Group members have also commenced, which have provided a fundamental solution for transplanting strategic execution.

The Company was awarded "Chinese Business 500" by *Yazhou Zhoukan* again during the year, making it the sixth consecutive year the Company gained this award. The Company's annual report 2005 was also awarded "Honourable Mention, Best Annual Report Awards" by The Hong Kong Management Association, which revealed that the Company's annual report has provided clear and accurate disclosure and has served the function of shareholder communication effectively. These awards also reflected the recognition of investors and professional institutions towards the Company's management quality and high degree of transparency. In future, management of the Group will endeavor to maintain and achieve beyond this outstanding performance and reputation that have been gained by the Company through challenging course.

Customer service

It is always the Group's believe that quality customer service is the key for maintaining good and long term relations between the Company and customers and the bedrock for the Group's sustainable business development. Succeeding from the recognition and credit obtained by 11 project companies of the Group from local customers as well as government authorities in the cities they operate last year, 12 project companies have obtained awards like "Units with High Consumer Satisfaction" and "Units Trusted by Consumers", etc, from the local consumer councils during the year.

During the year, the Group has introduced services qualification framework (Level 2 and 3) with Utilise Training & Development Solutions Limited. During the year, 58 sessions of training courses have been conducted and 600 participants joining the assessment have gained the qualification. Under the services qualification recognition framework, the customer services technique of employees has been improved, which in turn enhanced the quality of the Group's services.

At the same time, with a view to assessing the services quality objectively, strengthening control of services quality, and identifying the key factors of customers' satisfaction, the Group has collaborated with TNS China to develop a Xinao Gas customer services satisfaction research. The third-party inspection under this project can provide scientific evidence on eliminating customers dissatisfaction.

In 2006, seven more project companies of the Group also have launched the 95158 national customer service hotline, raising the number of project companies with 95158 services to 25. Our customers can simply dial 95158 to access their local 24-hour customer service centers, enabling hassle-free communication for customers with us.

In addition, the project companies of the Group follow the Group's unified requirements to visit customers for safety checks on customers' gas appliances twice a year. These measures, drawing on the concept of "prevention is better than cure", help to eliminate customers' worry on potential safety problems, and thus increase the trust of our customers.

Human resources

We always uphold the principles of "based on people" and believe that the creation of customers' satisfaction is rooted at healthy personal growth of employees. Therefore, we put great emphasis on recruitment and internal training. In 2006, subsidiaries of the Group have implemented competitional promotion system, where outstanding young employees were screened through internal selection and open competition and to be promoted as management. Through the series of measures, the mechanism of executive selection, training and promotion has been polished well for enhancing vitality of executive team.

Moreover, the Group has provided planned learning channels for employees as usual, and encourages staff to have lifelong learning. The Group offers learning and studying opportunities to employees as a form of benefits and rewards. We have invited reputational expertise and professors from universities around the world to provide two days of training every month to employees. In addition, we have sponsored some employees with development potential and enthusiasm in work to further study in renowned local and overseas universities, so as to enhance their competence, professional skills and quality. At the same time, new employees were provided with specialised practice and care of living to facilitate qualification acquisition of new employees within short period of time, and to foster new employees' ability to provide quality services by the time they participate in the work, so as to ensure smooth operation.

As at 31 December 2006, the Group had 13,355 employees, of which eight based in Hong Kong and the others based in the PRC. They were remunerated at market level with benefits like bonus, retirement benefits, insurance, professional training, share option scheme, etc.

Financial resources review

Liquidity and financial resources

As at 31 December 2006, the Group's cash on hand was equivalent to RMB1,567,552,000 (2005: RMB1,784,055,000), and its total debts was equivalent to RMB4,022,936,000 (2005: RMB3,654,669,000). Its net gearing ratio, i.e. the ratio of net debt to equity (excluding minority interests), was 80.3% (2005: 83.8%).

Under the US$25,000,000 Loan Agreements with IFC, the Company, Mr. Wang Yusuo ("Mr. Wang") and the Borrowers (i.e. Bengbu Xinao Gas Company Limited, Shijiazhuang Xinao Gas Company Limited and Xiangtan Xinao Gas Company Limited, subsidiaries of the Company) have entered into the Share Retention Agreements with IFC on 18 May 2004 whereby Mr. Wang has agreed, according to the Loan Agreement and the subsequent amendment thereto, that so long as any monies remain due or to become due and owing by the Borrowers to IFC under or in respect of the Loan Agreements, he and Ms. Zhao Baoju ("Ms. Zhao") will own, in aggregate, directly or, at any time that he and Ms. Zhao own in aggregate all the shares in the capital of Xinao Group International Investment Limited (formerly known as Easywin Enterprises Limited) ("XGII"), indirectly through XGII, at least 27% of the issued share capital of the Company. Mr. Wang and Ms. Zhao are the beneficial and legal owners of XGII, which is owned as to 50% by Mr. Wang and 50% by Ms. Zhao. As at 31 December 2006, XGII and Mr. Wang together held 35.13% interests of the Company.

Five-year zero coupon convertible bonds

The Company issued five-year convertible bonds ("CB" or "CBs") in an aggregate principal amount of HK$550,000,000 on 15 November 2004. The CBs are zero coupon bonds; the issue price is 100% whereas the redemption price is 106.43%, which means that the effective interest rate is 1.25% per annum. The bondholders have the option to require the Company to redeem the CBs 2.5 years after the issue date. If the bondholders do not exercise the option of redemption, then they have to hold the CBs to maturity or exercise the conversion right during the conversion period. Bondholders can exercise the conversion right between 15 December 2004 and 15 November 2009 and convert the CBs into ordinary shares of HK$0.10 each of the Company, and the Company has the option to issue share or pay cash in lieu of shares to such bondholders. The conversion price for each ordinary share at the issue date of the CBs was HK$5.4375, which is subject to adjustment for events, if any, which may have diluting effects after the issue.

As at 31 December 2006, HK$458,700,000 (equivalent to RMB460,856,000) of CBs was converted into 84,358,594 ordinary shares of the Company. There were HK$91,300,000 (equivalent to RMB91,729,000) of CBs outstanding. If all the outstanding CBs are converted into shares, around 16,790,804 ordinary shares of the Company will be issued, equivalent to 1.72% of the total issued share capital of the Company as at 31 December 2006.

Seven-year 7.375% fixed rate bonds

On 5 August 2005, the Company issued 7-year bonds in the aggregate principle amount of US$200,000,000 (equivalent to RMB1,614,040,000) with issue price and redemption price of 100%, which are unconditionally and irrevocably guaranteed by the guarantor subsidiaries. The guarantor subsidiaries are wholly-owned subsidiaries of the Company and are primarily holding companies that operate through subsidiaries. The coupon of the bonds is 7.375%, and interests are paid semi-annually.

As all the operations of the Group are in the PRC, if the appreciation of RMB would continue in the future, the Group will benefit from earning RMB and repaying foreign currency debts, the finance charges for foreign currency debt will be lowered indirectly.

Currently, the Group's operating and capital expenditures are funded by operating cash flow, internal liquidity, bank loans and issued bonds. The Group has sufficient sources of funds and unutilised banking facilities to meet the future capital expenditure and working capital requirements.

Borrowings structure

As at 31 December 2006, the Group's total bank and other borrowings amounted to RMB4,022,936,000 (2005: RMB3,654,669,000), including zero coupon CBs at fair value of HK$127,000,000 (equivalent to RMB127,597,000), loans and bonds of US$222,500,000 (equivalent to RMB1,737,436,000) and mortgage loans of HK$8,974,000 (equivalent to RMB9,016,000). Apart from the zero coupon CBs and the fixed rate US$200,000,000 bonds, other US dollar loans and HK dollar mortgage loans bear interest at floating rates, and the remaining bank and other borrowings are denominated in Renminbi at fixed interest rates or the interest rates released by the People's Bank of China. The project companies used the Renminbi loans as their working capital and operational expenditure. Except for the loan amount of RMB1,504,258,000 equivalent that has to be secured by assets with the net asset value of approximately RMB119,613,000 equivalent, all of the other loans are unsecured. Short-term loans amounted to RMB619,140,000 while the remaining were long-term loans falling due after more than a year. Details of capital commitments are set out in Note 43 to the Financial Statements.

As all the operations of the Group are in the PRC, revenues and expenses were mainly denominated in Renminbi. Hence, there were no significant foreign exchange exposures or risks. The Group has entered into interest rate swap contracts for the US dollar bonds. The Group will monitor the market trends of interest and exchange rates closely and make appropriate adjustments when necessary.