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If you are in any doubt as to any aspect of this circular or as to the action to be taken, you should consult your stockbroker or other registered dealer in securities, bank manager, solicitor, professional accountant or other professional adviser.

If you have sold or transferred all your shares in China Water Affairs Group Limited, you should at once hand this circular and the accompanying form of proxy to the purchaser or the transferee, or to the bank, stockbroker or other agent through whom the sale or the transfer was effected for transmission to the purchaser or the transferee.

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中國水務集團有限公司*
China Water Affairs Group Limited

(Incorporated in the Cayman Islands and continued in Bermuda with limited liability)
(Stock Code: 855)

**APPOINTMENT OF AUDITOR,
GRANT OF OPTIONS TO A DIRECTOR
UNDER THE SHARE OPTION SCHEME
AND
NOTICE OF SPECIAL GENERAL MEETING**

**Independent Financial Adviser to Independent Board Committee
and Independent Shareholders**



Menlo Capital Limited

A letter from the Board is set out on pages 3 to 5 of this circular. A letter from the Independent Board Committee containing its recommendations to the Independent Shareholders regarding the grant of the Director Options is set out on page 6 of this circular. A letter from Menlo Capital Limited, the independent financial adviser to the Independent Board Committee and the Independent Shareholders containing its advice regarding the Director Options is set out on pages 7 to 14 of this circular. A notice convening the special general meeting of the Company to be held at Suite 6408, 64/F, Central Plaza, 18 Harbour Road, Wanchai, Hong Kong on 5 January 2011 at 11:00 a.m. or any adjournment thereof is set out on pages 20 to 21 of this circular. Whether or not you intend to attend the special general meeting of the Company, you are advised to complete the accompanying proxy form in accordance with the instructions printed thereon and return the same to the Company's Share Registrar in Hong Kong, Tricor Tengis Limited, at 26th Floor, Tesbury Centre, 28 Queen's Road East, Wanchai, Hong Kong, not less than 48 hours before the time fixed for holding of the meeting or any adjournment thereof. Completion and delivery of the proxy form will not preclude Shareholders from attending and voting in person at the meeting if they so wish.

* For identification purposes only

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DEFINITIONS

In this circular, the following expressions shall have the following meanings unless the context requires otherwise:

“Asset Full”	Asset Full Resources Limited, a company incorporated in the British Virgin Islands, the entire issued share capital of which is beneficially owned by Mr Duan
“associates”	has the meaning ascribed to it in the Listing Rules
“Board”	the board of Directors of the Company or a duly authorized committee thereof for the time being
“Company”	China Water Affairs Group Limited, a company incorporated in the Cayman Islands and continued in Bermuda with limited liability
“Companies Ordinance”	the Companies Ordinance (Chapter 32 of the Laws of Hong Kong)
“connected persons”	has the meaning ascribed to it in the Listing Rules
“Date of Grant”	10 December 2010, being the date of the meeting of the Board granting the Director Options subject to Shareholders’ approval
“Directors”	directors of the Company
“Director Options”	the proposed grant of options to Mr Duan, particulars of which are set out in Appendix I
“Group”	the Company and its subsidiaries
“Hong Kong”	the Hong Kong Special Administrative Region of The People’s Republic of China
“HK\$”	Hong Kong dollars, the lawful currency of Hong Kong
“Independent Board Committee”	the independent committee of the Board comprising all the independent non-executive directors of the Company
“Independent Financial Adviser” or “Menlo Capital”	Menlo Capital Limited, the independent financial adviser to the Independent Board Committee and Independent Shareholders in relation to the Director Options which is a licensed corporation carrying out type 6 (advising on corporate finance) regulated activity

DEFINITIONS

“Independent Shareholders”	Shareholders other than Asset Full, Mr Duan and all other Directors and their respective associates
“Latest Practicable Date”	16 December 2010, being the latest practicable date prior to the printing of this circular for ascertaining certain information contained herein
“Listing Rules”	the Rules Governing the Listing of Securities on the Stock Exchange
“Mr Duan”	Mr Duan Chuan Liang, chairman and executive director of the Company
“Scheme Mandate Limit”	the total number of Shares (being up to 10% of Shares in issue at the date of the relevant general meeting) which may be issued upon exercise of all options to be granted under the Share Option Scheme as at the date of adoption of the Share Option Scheme or as refreshed
“Share Option Scheme”	the share option scheme adopted by the Company on 6 September 2002
“SFO”	The Securities and Future Ordinance (Chapter 571 of the Laws of Hong Kong)
“SGM”	the special general meeting of the Company to be held at Suite 6408, 64/F, Central Plaza, 18 Harbour Road, Wanchai, Hong Kong on 5 January 2011 at 11:00 a.m.
“Share(s)”	Share(s) of HK\$0.01 each in the capital of the Company (or of such other nominal amount as shall result from a sub-division, consolidation, reclassification or reconstruction of the share capital of the Company from time to time)
“Shareholder(s)”	holder(s) of Share(s)
“Stock Exchange”	The Stock Exchange of Hong Kong Limited
“%”	per cent

LETTER FROM THE BOARD



中國水務集團有限公司*

China Water Affairs Group Limited

(Incorporated in the Cayman Islands and continued in Bermuda with limited liability)

(Stock Code: 855)

Executive Directors

Mr Duan Chuan Liang (*Chairman*)
Mr Li Ji Sheng

Non-Executive Directors

Mr Chen Guo Ru
Mr Wu Jiesi
Mr Zhao Hai Hu
Mr Zhou Wen Zhi

Independent Non-Executive Directors

Ms Huang Shao Yun
Ms Liu Dong
Mr Chau Kam Wing
Mr Ong King Keung

Registered office

Clarendon House
2 Church Street
Hamilton HM 11
Bermuda

*Head office and principal place
of business on Hong Kong*

Suite 6408, 64/F
Central Plaza,
18 Harbour Road
Wanchai
Hong Kong

20 December 2010

To the Shareholders

Dear Sir and Madam,

**APPOINTMENT OF AUDITOR,
GRANT OF OPTIONS TO A DIRECTOR
UNDER THE SHARE OPTION SCHEME
AND
NOTICE OF SPECIAL GENERAL MEETING**

INTRODUCTION

The purpose of this circular is (i) to provide you with information on the appointment of the Auditor; (ii) to provide you with information on the grant of the Director Options under the Share Option Scheme; (iii) to set out the recommendations of the Independent Board Committee in relation to the Director Options (iv) to set out the recommendation of the Menlo Capital in relation to the Director Options and (v) to give you notice of the SGM at which ordinary resolutions will be proposed to consider and, if thought fit, approve the appointment of the Auditor and the grant of the Director Options under the Share Option Scheme.

* For identification purposes only

LETTER FROM THE BOARD

APPOINTMENT OF AUDITOR

Grant Thornton has resigned as auditor of the Group with effect from 6 December 2010.

The Board proposes to appoint BDO Limited as auditor of the Group to fill the casual vacancy occasioned by the resignation of Grant Thornton. Pursuant to the bye-laws of the Company, the SGM will be convened to approve BDO Limited's appointment. BDO Limited shall hold office until the conclusion of the next annual general meeting of the Company.

The reason for the change of auditor is due to a merger of the practices of Grant Thornton with that of BDO Limited, the Hong Kong member firm of the global BDO network.

Grant Thornton has confirmed that there were no circumstances connected with its resignation which it considers should be brought to the attention of the Shareholders.

Both the Board and its Audit Committee confirm that there is no disagreement between the Company and Grant Thornton and there are no circumstances in respect of the change of auditor which they consider should be brought to the attention of the Shareholders.

GRANT OF DIRECTOR OPTIONS

The Company announced on 10 December 2010 that it proposes to grant options to Mr. Duan to subscribe for 50,000,000 Shares, representing approximately 3.66% of the Shares in issue as at the Latest Practicable Date. The exercise price for the Director Options is HK\$3.00 per Share, which was determined on the Date of Grant.

As at the Latest Practicable Date, Mr Duan is holding 243,650,301 Shares representing approximately 17.86% of the issued share capital of the Company, which consist of 112,336,301 Shares held by Asset Full and 131,314,000 Shares held by Mr Duan personally. Mr Duan is holding 15,000,000 options under the Share Option Scheme as at the Latest Practicable Date. No option has been granted to Mr Duan within 12 months from the Date of Grant.

If the proposal to grant the Director Options is approved by the Shareholders, the total numbers of Shares issued and to be issued upon exercise of the Director Options (including exercised, cancelled and outstanding options) by Mr Duan in any 12-month period shall exceed 1% of all the Shares in issue (the "Individual Limit") and shall also represent in aggregate over 0.1% of all the Shares in issue and having an aggregate value in excess of HK\$5 million.

According to the Listing Rules, grant of options to each participant exceeding the 1% Individual Limit, or to a substantial shareholder or an independent non-executive or any of their respective associates exceeding 0.1% of the total number of shares in issue and having an aggregate value in excess of HK\$5 million, requires shareholders' approval in general meeting.

According to the Listing Rules, Mr. Duan and his associates and all connected persons of the Company will abstain from voting in favour of the resolution to approve the grant of the Director Options at the SGM.

LETTER FROM THE BOARD

Further details regarding the proposed grant of the Director Options are set out in Appendix I to this circular.

SGM

Approval from the Shareholders will be sought at the SGM for the appointment of BDO Limited as auditor of the Company and for approval of the grant of the Director Options to Mr Duan.

No shareholder is required to abstain from voting regarding the appointment of auditor.

Pursuant to the Listing Rules, Asset Full, Mr. Duan and all other Directors and their respective associates, all being connected persons of the Company, will abstain from voting in favour of and have no intention to vote against the resolution to approve the grant of the Director Options at the SGM.

The Independent Board Committee has been established to make recommendations to the Shareholders in respect of the grant of the Director Options.

Menlo Capital has been appointed as the independent financial adviser to advise the Independent Board Committee and the Independent Shareholders in respect of the grant of the Director Options.

RECOMMENDATION

Menlo Capital has been appointed to advise the Independent Board Committee and the Independent Shareholders with regard to the grant of the Director Options and consider that the grant of the Director Options is fair and reasonable so far as the interests of the Independent Shareholders are concerned. Your attention is drawn to the letter of advice from Menlo Capital containing its recommendation and the principal factors and reasons it has taken into account in arriving at its recommendation are set out in this circular.

The Independent Board Committee, having taken the advice of Menlo Capital into account, considers the terms of the grant of the Director Options fair and reasonable so far as the Independent Shareholders are concerned. Accordingly, the Independent Board Committee recommends the Independent Shareholders to vote in favour of the resolution relating to the grant of the Director Options. The full text of the letter from the Independent Board Committee is set out in this circular.

The Director Options has been approved by all independent non-executive directors. The Directors are of the opinion that the grant of the Director Options is fair and reasonable and in the interests of the Company and the Shareholders as a whole.

The Directors recommend that all Shareholders should vote in favour of the relevant resolutions to be proposed at the SGM.

Yours faithfully,
On behalf of the Board
DUAN CHUAN LIANG
Chairman

LETTER FROM THE INDEPENDENT BOARD COMMITTEE



中國水務集團有限公司*
China Water Affairs Group Limited

(Incorporated in the Cayman Islands and continued in Bermuda with limited liability)

(Stock Code: 855)

20 December 2010

To the Independent Shareholders

Dear Sir/Madam,

We have been appointed as the Independent Board Committee to advise Independent Shareholders in connection with the grant of the Director Options, details of which are set out in the circular of the Company to the Shareholders dated 20 December 2010 (the “Circular”), of which this letter forms part. Terms defined in the Circular shall have the same meanings when used herein unless the context otherwise requires.

Having considered the advice of Menlo Capital in relation thereto as set out in the Circular and Mr. Duan’s contribution to the Group and the terms of the proposed grant of Director Options, we are of the view that the terms of the proposed grant of Director Options to Mr. Duan are fair and reasonable so far as the Independent Shareholders are concerned.

Accordingly, we recommend the Independent Shareholders to vote in favour of the resolution to be proposed at the SGM to approve the grant of the Director Options to Mr Duan.

Yours faithfully

Huang Shao Yun
*Independent
non-executive
Director*

Liu Dong
*Independent
non-executive
Director*

Chau Kam Wing
*Independent
non-executive
Director*

Ong King Keung
*Independent
non-executive
Director*

* For identification purposes only

LETTER FROM MENLO CAPITAL

The following is the text of a letter from Menlo Capital Limited in connection with the proposed grant of the Director Options which has been prepared for the purpose of inclusion in this circular:



Menlo Capital Limited

Room 1807, West Tower, Shun Tak Centre
168 Connaught Road Central, Hong Kong

20 December 2010

*To the Independent Board Committee and the Independent Shareholders of
China Water Affairs Group Limited*

Dear Sirs,

GRANT OF OPTIONS TO A DIRECTOR UNDER THE SHARE OPTION SCHEME

INTRODUCTION

We refer to our engagement as the independent financial adviser to advise the Independent Board Committee and the Independent Shareholders on the grant of the Director Options, details of which are set out in the “Letter from the Board” in the circular (the “Circular”) issued by the Company to the Shareholders in 20 December 2010. Capitalised terms used in this letter shall have the same meanings ascribed to them in the Circular unless the context otherwise requires.

The Company proposes to grant of the Director Options to Mr. Duan to subscribe for 50,000,000 Shares under its Share Option Scheme, representing approximately 3.66% of the Shares in issue as at the Latest Practicable Date. According to the Listing Rules, grant of options to each participant exceeding the 1% individual limit, or to a substantial shareholder or an independent non-executive or any of their respective associates exceeding 0.1% of the total number of shares in issue and having an aggregate value in excess of HK\$5 million, requires shareholders’ approval in general meeting. Mr. Duan and his associates and all connected persons of the Company will abstain from voting in favour of the resolution to approve the grant of the Director Options at the SGM.

The Independent Board Committee, comprising Ms. Huang Shao Yun, Ms. Liu Dong, Mr. Chau Kam Wing and Mr. Ong King Keung, all being the independent non-executive Directors, has been formed to advise the Independent Shareholders as to whether the Director Options is in the interests of the Company and the Shareholders as a whole and whether the terms of the Director Options are fair and reasonable so far as the Independent Shareholders are concerned.

LETTER FROM MENLO CAPITAL

In formulating our opinion, we have relied on the accuracy of the information and representations contained in the Circular which have been provided to us by the Directors and which the Directors consider to be complete and relevant, and have assumed that the statements made were true, accurate and complete at the time they were made and continue to be true on the date of the Circular. We have also assumed that all statements of belief, opinion and intention made by the Directors in the Circular were reasonably made after due and careful enquiry and are based on honestly-held opinions. We have no reason to doubt the truth, accuracy and completeness of the information and representations provided to us by the Directors and we have been advised by the Directors that no material facts have been omitted from the information and representations provided in and referred to in the Circular.

We consider that we have received sufficient information to enable us to reach an informed view and to justify our reliance on the accuracy of the information and representations contained in the Circular and to provide a reasonable basis for our view and recommendation. We have no reason to suspect that any material information has been withheld by the Company or by the Directors. We have not, however, carried out any independent investigation into the business and affairs of the Group. We have taken all reasonable steps pursuant to rule 13.80 of the Listing Rules which include the following:

- (a) obtaining all the information and documents relevant to an assessment of the fairness and reasonableness of the terms of the Director Options, including but not limited to, the announcement of the Company dated 10 December 2010, the Letter from the Board, the annual reports of the Company for the years ended 31 March 2003, 31 March 2004, 31 March 2005, 31 March 2006, 31 March 2007, 31 March 2008, 31 March 2009 and 31 March 2010 and the interim report of the Company for the six months ended 30 September 2010;
- (b) reviewing the business performance and financial situation of the Company as well as the reasons and background of granting the Director Options; and
- (c) confirming that no valuation report is relevant to renewal of the grant of the Director Options.

PRINCIPAL FACTORS AND REASONS CONSIDERED

In arriving at our opinion and recommendation to the Independent Board Committee and the Independent Shareholders on the fairness and reasonableness of the terms of the Director Options, we have considered the following principal factors and reasons:

I. Background and reasons of the grant of the Director Options

The Group is principally engaged in city water supply and sewage treatment business in the PRC.

Mr. Duan joined the Group as the chairman and executive director of the Group in January 2003. Mr. Duan has been responsible for the overall strategic planning and formulation of corporate policies of the Group for almost eight years. He graduated from the North China College of Water Conservancy and Hydro Power with a bachelor degree, specialising in irrigation and water conservancy works. He had been working for the Water Conservancy Department of the PRC Government for more than ten years. The Board is of the view that the grant of the Director Options is an appropriate way to motivate Mr. Duan

LETTER FROM MENLO CAPITAL

who has contributed significantly to the growth of the Company and the development of the Group in urban water supply businesses without imposing substantial financial burden to the Group. The grant of the Director Options has been approved by the independent non-executive Directors who are of the view that Mr. Duan is valuable to the Group and should be rewarded for his contributions to the Group. The Board also considers that grant of the Director Options could ensure a firm bond between Mr. Duan and the Company, which will ultimately benefit the Company.

Based on the annual reports of the Company for the years ended 31 March 2003, 31 March 2004, 31 March 2005, 31 March 2006, 31 March 2007, 31 March 2008, 31 March 2009 and 31 March 2010 and the interim reports of the Company for the six months ended 30 September 2010, the revenue, the profit/(loss) from principal activities and the profit/(loss) from operation are summarised as follows:

Group performance (HK\$'000)	Year ended (Audited)						Six months ended (Unaudited)		
	31 March 2003	31 March 2004	31 March 2005 (restated)	31 March 2006	31 March 2007 (restated)	31 March 2008	31 March 2009	31 March 2010	30 Sep 2010
Revenue derived from principal activities	123,464	33,187	48,467	52,901	134,735	765,538	1,033,199	1,398,168	627,403
Cost of sales	(126,769)	(53,402)	(44,732)	(31,178)	(78,521)	(498,531)	(712,430)	(811,606)	(337,788)
Selling, administrative and general expenses	(22,201)	(13,977)	(12,941)	(32,342)	(77,242)	(152,559)	(229,877)	(296,887)	(158,424)
Profit/(loss) from principal activities	(25,506)	(34,192)	(9,206)	(10,619)	(21,028)	114,448	90,892	289,675	131,191
Valuation gain/(loss) on assets and other income (<i>note</i>)	1,564	(336)	(5,963)	(7,514)	170,284	249,813	304,272	343,270	289,615
Profit/(loss) from operation	(23,942)	(34,528)	(15,169)	(18,133)	149,256	364,261	395,164	632,945	431,944

Note: Valuation gain/(loss) on assets and other income consist of the valuation surplus/(deficiency) on investment properties, the fair value gain/(loss) on financial assets at fair value through profit or loss, the gain on early redemption on convertible bonds, the other income (including interest income, dividend income from financial assets and miscellaneous income), the equity-settled share options expenses and the change in fair value of derivative financial instruments and other income/expenses.

LETTER FROM MENLO CAPITAL

As stated in the above summary, the revenue derived from principal activities of the Group demonstrated a continuous and substantial growth in the six years from the financial year ended 31 March 2004 to the financial year ended 31 March 2010. The growth in the revenue derived from principal activities of the Group evidenced the contribution of Mr. Duan to (i) the overall strategic planning of the Group; (ii) the growth of the Company and the development of the Group in urban water supply businesses; (iii) the negotiation and completion of the investments in the new projects; and (iv) the management and operations of the existing businesses. We are of the view that the grant of the Director Options could ensure a firm bond between Mr. Duan and the Company, which will ultimately benefit the Company.

The results from the principal activities and from the operation experienced significant improvement from a loss in the financial years ended 31 March 2006 and 31 March 2007 to profit making for the three years ended 31 March 2010 which is continuing for the six months ended 30 September 2010.

As depicted above, we are of the view that the Director Options could ensure a firm bond between Mr. Duan and the Company, which will ultimately benefit the Company; and that the Company could receive the proceeds depending on the amount of the subscription right attaching to the Option to be exercised over the exercise period.

We are also of the view that the possible raising fund through the grant of the Director Options is an appropriate means of raising additional capital for the Company at the present situation as (i) the entering into of the grant of the Director Options by Mr. Duan also reflects the Chairman's confidence in the prospects of the Group and his commitment to maintain his shareholding in the Company; and (ii) if the subscription right attaching to the Director Options is exercised, the financial position of the Group will be improved as stated under the section "Financial Effects of the Director Options" in this letter. Accordingly, we consider that the grant of the Director Options will enhance the financial position of the Group, which is in the interest of the Company and the Shareholders as a whole.

II. Principle terms of the Director Options

The terms of the Director Options shall follow the terms of the Share Option Scheme. The offer of the grant of the Director Options may be accepted by Mr. Duan within 28 days from the date of offer and HK\$1 is payable by him to the Company on acceptance of the Director Options offer. There is no performance target that must be achieved before the Director Options can be exercised, the options may be exercised at any time during a period of 3 years from the date of grant of the options and there will be no lock-up period for exercise of options. The Share Option Scheme does not require a minimum period for which an Option must be held before it can be exercised.

Pursuant to the terms of the Share Option Scheme, the subscription price for Shares upon exercise of the Director Options is HK\$3.00 per Share (the "Exercise Price"), which was determined on the Date of Grant. The Exercise Price is higher than (i) the closing price of the Shares as stated in the daily quotation sheet issued by the Stock Exchange on the Date of Grant; (ii) the average closing price of the Shares as stated in the Stock Exchange's daily quotation sheets for the five business days immediately preceding the Date of Grant; and (iii) HK\$0.01, the nominal value of a Share.

LETTER FROM MENLO CAPITAL

The Shares to be allotted and issued upon the exercise of the Director Options will be subject to all the provisions of the Bye-Laws of the Company for the time being in force and will rank pari passu with the fully paid Shares in issue on the date the name of Mr. Duan is registered on the register of members of the Company. Prior to Mr. Duan being registered on the register of members of the Company, he shall not have any voting rights, or rights to participate in any dividends or other distributions in respect of the Shares to be issued upon the exercise of the Director Options.

Exercise Price

The following table sets out the historical monthly/period highest and lowest price of the Shares and the average daily closing price of the Shares traded on the Stock Exchange from 11 June 2010, being the six months prior to the Grant Date, to the Grant Date:

Month/period	Highest price of the month/ period (HK\$)	Lowest price of the month/ period (HK\$)	Average daily closing price of the month/period (HK\$)
2010			
June (<i>Note 1</i>)	2.81	2.44	2.61
July	2.94	2.42	2.63
August	2.92	2.54	2.72
September	2.90	2.70	2.81
October	3.39	2.80	3.07
November	3.19	2.93	3.02
December (<i>Note 2</i>)	3.11	2.92	2.97

Note:

1. From 11 June 2010 to 30 June 2010.
2. The trading days prior to 10 December 2010.

The above table shows that the exercise prices of the Director Options of HK\$3.00 per Share is (i) slightly higher than the closing price of HK\$2.93 of the Shares as quoted on the Stock Exchange on the Date of Grant; (ii) slightly higher than the average closing price of HK\$2.95 of the Shares as quoted on the Stock Exchange for the five business days immediately preceding the Date of Grant; (iii) slightly higher than the average closing price of HK\$2.98 of the Shares as quoted on the Stock Exchange for the ten business days immediately preceding the Date of Grant; (iv) slightly higher than average closing price for the three calendar months from 13 September 2010 to the Date of Grant of HK\$2.99 of the Shares; and (v) higher than the average closing price for the six calendar months from 11 June 2010 to the Date of Grant of HK\$2.83 of the Shares as quoted on the Stock Exchange.

LETTER FROM MENLO CAPITAL

We are of the view that the possible raising fund through the Director Options is an appropriate means of raising additional capital for the Company at the present situation as (i) the exercise price for the grant of the Director Options is higher than the closing price of HK\$2.93 of the Shares as quoted on the Stock Exchange on the Date of Grant and all the average closing prices of the Shares as mentioned above; (ii) in the event the subscription right attaching to the Option is exercised, the financial position of the Group will be improved; and (iii) the terms of the Director Options shall follow the terms of the Share Option Scheme. Accordingly, we consider that the principal terms of the Director Options including the exercise price for the grant of the Director Options are fair and reasonable so far Independent Shareholders are concerned.

III. Financial effects of the Director Options

(i) Indebtedness

There is no change in the indebtedness of the Group as the Group will not incur or reduce any indebtedness under the grant of the Director Options or the exercise of the subscription right attaching to the Director Options, if any.

(ii) Working capital

In the event that Mr. Duan exercises the subscription right of the Director Options in any amount, the working capital of the Company will be improved. In the event that Mr. Duan exercises the subscription right of the Director Options in full, the working capital of the Company will be improved by HK\$150 million.

(iii) Net assets values

In the event that Mr. Duan exercises the subscription right of the Option in the future, the net asset value of the Company will be improved, with a maximum amount of HK\$150 million under full exercise of the subscription right of the Director Options.

We are of the view that the grant of the Director Options and improve the financial position of the Group as a whole which is in the interests of the Company and the Shareholders as a whole.

IV. Dilution effect on the shareholding of the Independent Shareholders

As at the Latest Practicable Date, Mr. Duan is interested in 243,650,301 Shares representing approximately 17.86% of the issued share capital of the Company, which consist of 112,336,301 Shares held by Asset Full, and 131,314,000 Shares held by Mr. Duan personally. Mr. Duan is holding 15,000,000 options under the Share Option Scheme as at the Latest Practicable Date. No option has been granted to Mr. Duan within 12 months from the date of Grant.

LETTER FROM MENLO CAPITAL

The shareholding structure of the Company before and after full exercise of the Director Options is summarised as follows (calculated based on the number of Shares in issue on the Latest Practicable Date):

	Immediately prior to grant of Director Options		Assuming full exercise of the Director Options and other outstanding options held by Mr. Duan but before exercise of any outstanding convertible bonds, share options and warrants		Assuming full exercise of the Director Options and other outstanding options held by Mr. Duan and full exercise of all outstanding convertible bonds, share options and warrants	
			<i>No. of shares</i>	<i>%</i>	<i>No. of shares</i>	<i>%</i>
Mr. Duan (<i>note</i>)	243,650,301	17.86	308,650,301	21.59	308,650,301	19.11
Chen Guo Ru	3,500,000	0.26	3,500,000	0.24	4,000,000	0.25
Zhao Hai Hu	1,900,000	0.14	1,900,000	0.13	2,900,000	0.18
Zhou Wen Zhi	870,000	0.06	870,000	0.06	1,370,000	0.08
Wu Jiesi	0	0.00	0	0.00	6,500,000	0.40
Li Ji Sheng	0	0.00	0	0.00	1,000,000	0.06
Other option holders	0	0.00	0	0.00	11,200,000	0.69
CB holders	0	0.00	0	0.00	152,671,756	9.45
Warrant holders	0	0.00	0	0.00	12,031,393	0.74
Public	1,114,551,919	81.68	1,114,551,919	77.98	1,114,551,919	69.04
	<hr/>		<hr/>		<hr/>	
Total	<u>1,364,472,220</u>	<u>100.00</u>	<u>1,429,472,220</u>	<u>100.00</u>	<u>1,614,875,369</u>	<u>100.00</u>

Notes: The 243,650,301 Shares consist of 112,336,301 Shares held by Asset Full which is a company wholly and beneficially owned by Mr. Duan, and 131,314,000 Shares held by Mr. Duan personally.

Assuming exercise in full of the subscription rights attaching to the Director Options by Mr. Duan and no conversion of the convertible bonds, the share options and warrants the shareholding in the Company of the existing Independent Shareholders will be diluted from 81.68% to that of 77.98%. Assuming exercise in full of the subscription rights attaching to the Director Options by Mr. Duan and full conversion of the all outstanding convertible bonds, share options and warrants, the shareholding in the Company of the existing public Independent Shareholders will be diluted from 81.68% to that of 69.04%. As the grant of the Director Options is in the interest of the Company and the Shareholders as a whole and the terms of the Director Options are fair and reasonable so far as the Independent Shareholders are concerned, we consider the potential dilution to shareholding of the Independent Shareholders in relation to the Director Options is fair and reasonable.

LETTER FROM MENLO CAPITAL

VI. RECOMMENDATION

We have taken into consideration of the above principal factors and reasons:

1. the growth in the revenue derived from principal activities of the Group evidenced the contribution of Mr. Duan;
2. the Director Options is an appropriate way to motivate Mr. Duan without imposing financial burden to the Group;
3. that grant of the Director Options could ensure a firm bond between Mr. Duan and the Company;
4. the exercise of the subscription right of the Director Options, if any, will improve the working capital of the Company;
5. the exercise prices of the Director Options of HK\$3.00 per Share is fair and reasonable so far Independent Shareholders are concerned;
6. the exercise of the subscription right of the Option in the future, the net asset value of the Company will be improved, with a maximum amount of HK\$150 million under full exercise of the subscription right of the Director Options;
7. the entering into of the grant of the Director Options reflects the Chairman's confidence in the prospects of the Group and his commitment to maintain his shareholding in the Company; and
8. the potential dilution to shareholding of the Independent Shareholders in relation to the Director Options is fair and reasonable.

Taking into consideration of the above principal factors, we are of the view that the grant of the Director Options is in the interests of the Company and the Shareholders and the terms of the grant of the Director Options is fair and reasonable so far as the Independent Shareholders are concerned. Accordingly, we recommend the Independent Board Committee to advise the Independent Shareholders to vote in favour of the ordinary resolution to be proposed at the SGM to approve the grant of the Director Options.

Yours faithfully,
For and on behalf of
Menlo Capital Limited
Michael Leung
Director

This Appendix provides information as required by the Listing Rules to be provided to Shareholders for their consideration as to whether to vote for or against the resolution to be proposed at the SGM in relation to the grant of the Director Options to Mr Duan, which exceeds the Individual Limit and represent in aggregate over 0.1% of all the Shares in issue and have an aggregate value of over HK\$5 million.

PARTICIPANT AND NUMBER OF OPTIONS TO BE GRANTED

Upon the passing of the resolution approving the grant of the Director Options, the total number of Shares to be issued upon the exercise of the Director Options and the percentage of total issued share capital of the Company, calculated based on the number of Shares in issue on the Latest Practicable Date, is as follows:

Name of Grantee	Capacity	No. of Shares to be issued upon exercise of the Director Options	Percentage of total no. of Shares in issue
Mr Duan	Chairman and executive director	50,000,000	3.66%

As at the Latest Practicable Date, Mr Duan is holding 15,000,000 options under the Share Option Scheme.

Pursuant to the shareholders resolution at the annual general meeting of the Company on 7 September 2007, the Scheme Mandate Limit was refreshed to 123,681,422 Shares. As at the Latest Practicable Date, 64,000,000 options have been granted since refreshment of the Scheme Mandate Limit.

The shareholding structure of the Company before and after full exercise of the Director Options is summarised as follows (calculated based on the number of Shares in issue on the Latest Practicable Date):

	Immediately prior to grant of Director Options		Assuming full exercise of the Director Options and other outstanding options held by Mr Duan but before exercise of any outstanding convertible bonds (“CB”), share options and warrants		Assuming full exercise of the Director Options and other outstanding options held by Mr Duan and full exercise of all outstanding convertible bonds, share options and warrants	
	<i>No. of shares</i>	<i>%</i>	<i>No. of shares</i>	<i>%</i>	<i>No. of shares</i>	<i>%</i>
Mr Duan (<i>note 1</i>)	243,650,301	17.86	308,650,301	21.59	308,650,301	19.11
Chen Guo Ru	3,500,000	0.26	3,500,000	0.24	4,000,000	0.25
Zhao Hai Hu	1,900,000	0.14	1,900,000	0.13	2,900,000	0.18
Zhou Wen Zhi	870,000	0.06	870,000	0.06	1,370,000	0.08
Wu Jiesi	0	0.00	0	0.00	6,500,000	0.40
Li Ji Sheng	0	0.00	0	0.00	1,000,000	0.06
Other option holders	0	0.00	0	0.00	11,200,000	0.69
CB holders	0	0.00	0	0.00	152,671,756	9.45
Warrant holders	0	0.00	0	0.00	12,031,393	0.74
Public	1,114,551,919	81.68	1,114,551,919	77.98	1,114,551,919	69.04
Total	1,364,472,220	100.00	1,429,472,220	100.00	1,614,875,369	100.00

Notes:

- The 243,650,301 Shares consist of 112,336,301 Shares held by Asset Full which is a company wholly and beneficially owned by Mr Duan, and 131,314,000 Shares held by Mr Duan personally.

REASONS

Mr Duan is the chairman and executive director of the Group. Mr Duan is responsible for the overall strategic planning and formulation of corporate policies of the Group. He graduated from the North China College of Water Conservancy and Hydro Power with a bachelor degree, specialising in irrigation and water conservancy works. He had been working for the Water Conservancy Department of the PRC Government for more than ten years. The Board is of the view that the grant of the Director Options is an appropriate way to motivate Mr. Duan who has contributed significantly to the growth of the Company and the development of the Group in urban water supply businesses without imposing substantial financial burden to the Group. The grant of the Director Options has been approved by the Independent non-executive Directors who are of the view that Mr Duan is valuable to the Group and should be rewarded for his contributions to the Group. The Board also consider that grant of the Director Options could ensure a firm bond between Mr Duan and the Company, which will ultimately benefit the Company.

TERMS OF THE DIRECTOR OPTIONS

The terms of the Director Options shall follow the terms of the Share Option Scheme. The offer of the grant of the Director Options may be accepted by Mr Duan within 28 days from the date of offer and HK\$1 is payable by him to the Company on acceptance of the Director Options offer. There is no performance target that must be achieved before the Director Options can be exercised, the options may be exercised at any time during a period of 3 years from the date of grant of the options and there will be no lock-up period for exercise of options. The Share Option Scheme does not require a minimum period for which an Option must be held before it can be exercised.

Pursuant to the terms of the Share Option Scheme, the subscription price for Shares upon exercise of the Director Options is HK\$3.00 per Share (the “Exercise Price”), which was determined on the Date of Grant. The Exercise Price is higher than (i) the closing price of the Shares as stated in the daily quotation sheet issued by the Stock Exchange on the Date of Grant; (ii) the average closing price of the Shares as stated in the Stock Exchange’s daily quotation sheets for the five business days immediately preceding the Date of Grant; and (iii) HK\$0.01, the nominal value of a Share.

The Shares to be allotted and issued upon the exercise of the Director Options will be subject to all the provisions of the Bye-Laws of the Company for the time being in force and will rank *pari passu* with the fully paid Shares in issue on the date the name of Mr Duan is registered on the register of members of the Company. Prior to Mr Duan being registered on the register of members of the Company, he shall not have any voting rights, or rights to participate in any dividends or other distributions in respect of the Shares to be issued upon the exercise of the Director Options.

1. RESPONSIBILITY STATEMENT

This circular, for which the Directors collectively and individually accept full responsibility, includes particulars given in compliance with the Listing Rules for the purpose of giving information with regard to the Company. The Directors, having made all reasonable enquiries, confirm that to the best of their knowledge and belief the information contained in this circular is accurate and complete in all material respects and not misleading or deceptive, and there are no other matters the omission of which would make any statement herein or this circular misleading.

2. SHARE CAPITAL

(a) Share Capital

The authorised and issued share capital of the Company were summarised as follows:

HK\$

Authorised:

<u>20,000,000,000</u> Ordinary shares of HK\$0.01 each	<u>200,000,000</u>
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Issued and fully paid:

<u>1,364,472,220</u> Ordinary shares of HK\$0.01 each	<u>13,644,722.20</u>
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(b) Share Options

Details of the share options granted under the Share Option Scheme and remain outstanding as at the Latest Practicable Date are as follows:

Grantee	No. of Shares	Date of grant	Exercise price HK\$
Mr Duan	15,000,000	12 January 2009	1.02
Zhou Wen Zhi	500,000	10 December 2009	2.85
Chen Guo Ru	500,000	10 December 2009	2.85
Zhao Hai Hu	1,000,000	10 December 2009	2.85
Li Ji Sheng	1,000,000	10 December 2009	2.85
Wu Jiesi	6,000,000	29 March 2006	1.45
	500,000	10 December 2009	2.85
Others	400,000	17 March 2006	1.16
	300,000	29 March 2006	1.45
	10,500,000	10 December 2009	2.85

3. GENERAL

- (i) The company secretary of the Company is Mr. Tam Chun Yip, an associate member of the Association of Chartered Certified Accountants and a member of the Hong Kong Institute of Certified Public Accountants.
- (ii) The registered office of the Company is at Clarendon House, 2 Church Street, Hamilton HM 11, Bermuda.
- (iii) The head office and principal place of business of the Company in Hong Kong is at Suite 6408, 64/F, Central Plaza, 18 Harbour Road, Wanchai, Hong Kong.
- (iv) In case of inconsistency, the English text of this circular shall prevail over the Chinese text.

NOTICE OF SPECIAL GENERAL MEETING



中國水務集團有限公司* China Water Affairs Group Limited

(Incorporated in the Cayman Islands and continued in Bermuda with limited liability)

(Stock Code: 855)

NOTICE OF SPECIAL GENERAL MEETING

NOTICE IS HEREBY GIVEN that a special general meeting of China Water Affairs Group Limited (the “Company”) will be held at 11:00 a.m. on 5 January 2011 at Suite 6408, 64/F, Central Plaza, 18 Harbour Road, Wanchai, Hong Kong for the following purposes:

As special business, to consider and, if thought fit, pass the following resolution, which will be proposed with or without amendments, as ordinary resolutions:

ORDINARY RESOLUTIONS

1. “To appoint BDO Limited as auditor of the Company and to authorize the board of directors to determine their remuneration.”
2. “**THAT** the grant of options to Mr. Duan Chuan Liang (details of which are included in the circular to shareholders of the Company dated 20 December 2010), pursuant to the share option scheme of the Company adopted on 6 September 2002, entitling him to subscribe for shares of the Company in excess of 1% of the shares of the Company in issue at the date of passing this Resolution and with an aggregate value of over HK\$5 million be and is hereby approved and the directors of the Company (“the Directors”) be and are hereby authorized to issue and allot shares to him pursuant to the exercise of such options and to do such things and acts as may be necessary or expedient in the opinion of the Directors in order to give full effect to such grant of options.”

By Order of the Board
China Water Affairs Group Limited
Duan Chuan Liang
Chairman

As at the date of this notice, the Board comprises two executive Directors, being Mr. Duan Chuan Liang and Mr. Li Ji Sheng, four non-executive Directors, being Mr. Chen Guo Ru, Mr. Wu Jiesi, Mr. Zhao Hai Hu and Mr. Zhou Wen Zhi, and four independent non-executive Directors, being Ms. Huang Shao Yun, Ms. Liu Dong, Mr. Chau Kam Wing and Mr. Ong King Keung.

Hong Kong, 20 December 2010

* For identification purposes only

NOTICE OF SPECIAL GENERAL MEETING

Notes:

1. A member of the Company entitled to attend and vote at the meeting shall be entitled to appoint another person as his proxy to attend and vote instead of him. A proxy need not be a member of the Company. In addition, a proxy or proxies representing either an individual member or a member which is a corporation shall be entitled to exercise the same powers on behalf of the member which he or they represent as such member could exercise.
2. The instrument appointing a proxy shall be in writing under the hand of the appointer or of his attorney duly authorised in writing or, if the appointer is a corporation, either under its seal or under the hand of an officer, attorney or other person duly authorised.
3. The instrument appointing a proxy and the power of attorney or other authority, if any, under which it is signed or a certified copy of such power or authority shall be deposited to the Company's Share Registrar in Hong Kong, Tricor Tengis Limited, at 26th Floor, Tesbury Centre, 28 Queen's Road East, Hong Kong not less than 48 hours before the time fixed for holding the meeting.
4. Delivery of an instrument appointing a proxy shall not preclude a member from attending and voting in person at the meeting convened or upon the poll concerned and in such event, the instrument appointing a proxy shall be deemed to be revoked.
5. Where there are joint registered holders of any Shares, any one of such joint holders may vote either personally or by proxy in respect of such Shares as if he/she was solely entitled thereto; but if more than one of such joint holders be present at the Meeting personally or by proxy, that one of the said persons so present whose name stands first on the register in respect of such Share shall alone be entitled to vote in respect thereof.