

OVERVIEW

The Parent Company has been engaged in the research and development of electric locomotives and related products since 1959 and has been a main driving force in the development of the PRC locomotive industry. The Parent Company is held as to 51% by CSR and as to 49% by CNR. Until the Reorganisation, the principal business of the Parent Company was the research, manufacture and sale of (i) electrical systems and components for railways, electric automobiles and other applications and (ii) mechanical and synthetic products for railway systems. All of the business of the Company were undertaken by the Parent Company.

Pursuant to the Reorganisation in preparation for the Global Offering, the Parent Company subscribed for 94.06% of the Company's equity capital with net assets equivalent to RMB629,811,637. The details of the Reorganisation are set out in "History and Development — Reorganisation".

At the time of the incorporation of the Company on 26 September 2005, the Parent Company held 94.06% of the equity interest in the Company. Immediately after completion of the Global Offering (assuming that the Over-allotment Option is not exercised), the Parent Company will hold approximately 57.74% of the issued share capital of the Company and will continue to be the controlling shareholder of the Company. As the controlling shareholder of the Company, the Parent Company is able to exercise all the rights of a controlling shareholder, including election of Directors and voting on amendments to the Articles of Association.

TRANSACTIONS WITH THE PARENT COMPANY AND ITS SHAREHOLDERS

The Company has entered into a number of agreements with the Parent Company in respect of the regulation of the ongoing business relationship between the Group and the Parent Company. Upon the listing of the Company's H Shares on the Stock Exchange and for so long as the Parent Company is a substantial shareholder of the Company, transactions between members of the Group and the Parent Company and its associates pursuant to these agreements will constitute connected transactions for the Company under the Listing Rules. Details of these agreements are set out in the paragraph headed "Connected Transactions" below.

The Parent Company is held as to 51% by CSR and as to 49% by CNR. Upon the listing of the Company's H Shares on the Stock Exchange and for so long as the Parent Company is a substantial shareholder of the Company, CSR will be regarded as a connected person and transactions between members of the Group and CSR and its associates will constitute connected transactions for the Company under the Listing Rules. CSR and the Company have entered into transactions which constitute continuing connected transactions for the Company. The details of such continuing connected transactions are set out in the section headed "Connected transactions" below.

CSR AND CNR**History of CSR and CNR**

The PRC railway vehicle manufacturing industry was established in the 1950s. The Industrial Bureau of the MOR was formed as a governmental body to supervise the various state-owned rail vehicle manufacturing enterprises and review their performances. The state-owned railway vehicle manufacturing enterprises were responsible for their own business operations. They, independently or jointly with other enterprises, manufactured and supplied railway vehicles and related products to the MOR.

With the introduction of the open-door policy in China, LORIC was established in 1986 to take over the role of the Industrial Bureau of the MOR. In 2002, LORIC was split into CNR and CSR. Both CNR and CSR function as holding entities of subsidiary rail vehicle manufacturing enterprises, which carry out their business operations. All state-owned railway vehicle manufacturing enterprises (excluding Kunming China Railway which primarily manufactures large railway maintenance vehicles) in the PRC are owned by CNR and/or CSR. Following the restructuring of LORIC, CNR and CSR became the dominant suppliers of rail vehicles and related products to MOR. CSR and CNR, like the previous Industrial Bureau of the MOR and LORIC, primarily supervise their subsidiaries and review their performances.

Relationship with CSR and CNR

CNR holds a 49% interest in the Parent Company. CNR, together with CSR, are state-owned enterprises established in 2002 as a result of the restructuring of LORIC as part of the state's policy of encouraging competition in the railway locomotive and rolling stock markets in the PRC. CNR and its subsidiaries are mainly engaged in the development and manufacture of rail vehicles (excluding large railway maintenance vehicles) and related electrical and mechanical systems and components in the PRC. As CNR is only interested in 49% of the Parent Company, the accounts of the Parent Company are not consolidated with the consolidated accounts of CNR and the Parent Company is not accounted for as a subsidiary of CNR.

Immediately prior to the restructuring of LORIC in 2002, there were four research institutes controlled by LORIC, namely the Parent Company, Qishuyan Rolling Stock Manufacturing Technology Research Institute, Dalian Diesel Locomotive Research Institute and Qingdao Sifang Vehicle Research Institute. As part of the restructuring of LORIC, a 51% interest in both the Parent Company and Qishuyan Rolling Stock Manufacturing Technology Research Institute was allocated to CSR, whereas a 51% interest in both Dalian Diesel Locomotive Research Institute and Qingdao Sifang Vehicle Research Institute was allocated to CNR. The remaining 49% interest of each of the Parent Company and Qishuyan Rolling Stock Manufacturing Technology Research Institute was allocated to CNR and likewise, the remaining 49% interest in each of Dalian Diesel Locomotive Research Institute and Qingdao Sifang Vehicle Research Institute was allocated to CSR. Because of the cross shareholding of CSR and CNR in these institutes and the fact that the businesses of the CSR-controlled institutes and the CNR-controlled institutes are to some extent in competition with each other, consensus has been reached between CSR and CNR since their establishment that both of them have relinquished their respective rights to nominate or appoint any members of

the management of the relevant institute not controlled by it or to attend any management committee or equivalent meetings to approve or oppose any matters concerning such institute as a matter of practice in order to ensure smooth running of these institutes. However, no agreement or document, whether in writing or not, has been entered into between CSR and CNR in respect of such consensus or practice.

The Parent Company is an enterprise established under the Law of the PRC on Enterprises Owned by the Whole People and does not have a board of directors. Instead, it has a management committee consisting of a director (所長) and deputy directors (副所長) who together with the other senior management are responsible for the management of the Parent Company. CSR has, since its establishment, been responsible for the appointment of all members of the management committee of the Parent Company. CNR has not nominated any person to represent its interest on the management committee of the Parent Company and CNR has not directly or indirectly nominated or influenced the nomination of any person to the board of directors of the Company.

As CNR does not control the composition of the management committee of the Parent Company (including the right to appoint or remove a majority of the management committee members of the Parent Company) or control half of the voting power at the general meetings of the Parent Company, the Parent Company is not considered a subsidiary of CNR and accordingly, CNR is not regarded as an associate of the Parent Company and therefore not a connected person of the Company.

COMPETITION

The Company is the only manufacturer of train-borne electrical systems, power semiconductor devices and sensors and related products in the CSR Group. The other members of the CSR Group (excluding the Parent Group) are primarily engaged in research, development and manufacture of rail vehicles (excluding large railway maintenance vehicles), traction motors and transformers.

The Parent Company has retained certain businesses relating to the manufacture of mechanical equipment for locomotives and passenger cars or freight cars. The electrical components and systems manufacturing businesses retained by the Parent Company are used for road transportation and various other industrial applications. The Parent Company and the Company also focus on different customers. The customers of the Group's products are primarily train-borne electrical systems users, including locomotives, passenger cars or freight cars manufacturers, the customers of the Parent Company include primarily metal processing and mining enterprises, chemical engineering and power transmission enterprises and electric automobile manufacturers. As a result of the above differences, the Group's and the Parent Company's supply sources for raw materials, parts and components are also largely different, although they may share a limited number of suppliers for certain basic components such as steel profiles, aluminium profiles and electronic chips. However, due to the abundant supply of such basic components in the market, the Company can easily switched to other suppliers if required.

RELATIONSHIP WITH THE PARENT COMPANY AND CONNECTED TRANSACTIONS

The retained businesses of the Parent Company are managed independently from the business of the Company. Although Mr. Liao Bin and Mr. Tian Lei, both being Directors who also hold positions in the Parent Company, there is no overlap in the day-to-day management between the Company.

As the products and services undertaken by the Parent Company and CSR are either assembly of locomotives, passenger and freight cars or are mechanical rather than electrical in nature and are being managed independently from that of the Group, the Directors do not consider that the retained businesses of either the Parent Company or CSR are in competition with those of the Group, as they have different applications and functions, use different technologies and target different customers.

For the purposes of the listing of the Company's H Shares on the Stock Exchange, each of CSR and the Parent Company has entered into a non-competition agreement (the "Non-competition Agreement") with the Company, pursuant to which each of CSR and the Parent Company has undertaken not to compete with the businesses undertaken by the Group, which have been defined in the Non-Competition Agreement as the research, development, production and sale of train power converters, auxiliary power supply equipment and control systems, train operation safety equipment, electrical control systems for large railway maintenance vehicles, power semiconductor devices, sensors and related products and other electrical components for train-borne electrical systems and related applications.

The Non-competition Agreement contains, among other things, the following non-competition undertakings by each of CSR and the Parent Company to the Company:

- Neither CSR nor the Parent Company will, and each will procure that its subsidiaries will not, without the Company's prior written consent, participate, conduct or operate any businesses or services that will compete directly with the businesses undertaken by the Group.

The Non-competition Agreement will automatically lapse if CSR and the Parent Company cease to be the controlling shareholders of the Company. In order to promote good corporate governance practices and to improve transparency, the Non-Competition Agreement includes provisions that:

- the independent non-executive Directors will review, at least on an annual basis, the compliance of the Non-competition Agreement by the Parent Company and CSR;
- each of the Parent Company and CSR has undertaken to the Company that it will provide all information necessary for the annual review by the independent non-executive Directors for the enforcement of the Non-competition Agreement;
- the Company will disclose the review by the independent non-executive Directors on compliance with the Non-competition Agreement in its annual report and in case of non-compliance with the Non-competition Agreement by either the Parent Company or CSR, the Company will make announcements as appropriate in compliance with the Listing Rules; and

- the Parent Company and CSR will make an annual declaration in the annual report of the Company on compliance with the Non-competition Agreement in accordance with the principle of voluntary disclosures in the Corporate Governance Report.

INDEPENDENCE FROM THE PARENT COMPANY

Having considered the following factors, the Company is satisfied that the Company can conduct its business independently from the Parent Company after the Global Offering.

Independent board and management

Neither CSR nor the Parent Company has a board of directors due to each of their corporate nature as state-owned enterprises. Instead, each of them has a management team. The composition of the management team of each of CSR and the Parent Company is set out below:

CSR

Zhao Xiaogang, 趙小剛	General Manager and Deputy Party Secretary
Zheng Changhong, 鄭昌泓	Party Secretary and Deputy General Manager
Tang Kelin, 唐克林	Deputy General Manager
Zhang Jun, 張軍	Deputy Party Secretary, Secretary of the Disciplinary Supervision Committee and Chairman of Union
Fu Jianguo, 傅建國	Deputy General Manager
Liu Hualong, 劉化龍	Deputy General Manager
Zhan Yanjing, 詹艷景	Chief Accountant

None of the management personnel of CSR holds any position in the Company or any other member of the Group.

Parent Company

Liao Bin, 廖斌	Director (所長) and Deputy Party Secretary
Tian Lei, 田磊	Party Secretary and Deputy Director (副所長)
Song Yali, 宋亞立	Deputy Director (副所長)
Deng Huijin, 鄧恢金	Deputy Party Secretary, Secretary of the Disciplinary Supervision Committee and Chairman of Union
Liu Liangen, 劉連根	Deputy Director (副所長)
Zhang Liqiang, 張力強	Chief Accountant

Mr. Liao Bin, the Chairman and a non-executive Director, and Mr. Tian Lei, the Vice Chairman and non-executive Director, are also the director (所長) and deputy party secretary and party secretary and deputy director (副所長) of the Parent Company, respectively. Mr. Zhang Liqiang is also a supervisor of the Company. Save for Mr. Liao, Mr. Tian and Mr. Zhang, none of the other management personnel of the Parent Company holds any position in the Company or any other member of the Group.

RELATIONSHIP WITH THE PARENT COMPANY AND CONNECTED TRANSACTIONS

Mr. Liao and Mr. Tian maintain their dual roles with the Company and the Parent Company for the overall benefit of the Company. First, as the Company was established through the reorganisation of the Parent Company, Mr. Liao's and Mr. Tian's continued presence at both companies would ensure the continuity and stability of operations of the Company. Second, Mr. Liao's and Mr. Tian's continued presence at the Company and the Parent Company would ensure better coordination and efficiency in relation to business dealings between the two companies. The requirement for their dual-role appointments is in accordance with the Nomination of Directors and Supervisors Administration Measures approved by CSR under its power of personnel appointment and dismissal granted by SASAC.

The Board, which includes five independent non-executive Directors, will function independently from the Parent Company. In addition, the senior management of the Company is independent from the management of the Parent Company and all personnel involved in production and management of the Company's business were transferred to the Company during the Reorganisation.

Owing to the overlap of management roles of Mr. Liao and Mr. Tian, Mr. Liao and Mr. Tian would be required to abstain from voting on any Board resolution that concerns the Parent Company and is in conflict with the interests of the Company. The Board, excluding Mr. Liao and Mr. Tian, has two executive Directors, one non-executive Director and five independent non-executive Directors, and can independently decide on matters that concern the operation and management of the Company and determine whether or not the resolution is fair and reasonable and is in the interests of the Company and the Shareholders as a whole. In the event that the issue at hand is resolved not to be in the interests of the Company and the Shareholders, the Board may either reject the proposed resolution or consult with the compliance advisers, financial adviser or independent financial adviser, as appropriate.

Non-competition undertaking

As stated in the sub-section headed "Competition" in this section, the Directors believe that the Company will not face significant competition, whether directly or indirectly, from the Parent Company.

Business operations and financial independence

The Company is principally engaged in the research, development, design, manufacture and sale of train-borne electrical systems and electrical components. The Company possesses its own research and manufacturing facilities and has its own sales and purchases teams and does not rely on the Parent Company for the provision of any research, manufacturing, purchases or sales services. The Company has independent access to its suppliers and customers. Although due to the unique nature of the railway industry in the PRC that two subsidiaries of CSR are the Group's top five customers and a subsidiary of the Parent Company and a subsidiary of CSR are the Group's top two suppliers, the Company makes its business decisions independently and all sales and purchases are conducted on an arm's length basis under normal commercial terms. The

RELATIONSHIP WITH THE PARENT COMPANY AND CONNECTED TRANSACTIONS

Group is in possession of all relevant licenses necessary to carry out its business and has sufficient capital, equipment and employees to operate its business independently. Moreover, pursuant to the transfer of certain of the licenses and qualifications in rail related business to the Company by the Parent Company, the Parent Company is no longer in possession of certain of the required qualifications to conduct rail related businesses and thus it is not in competition with the business of the Group.

The Company has also established its own financial system independent from that of the Parent Company and the Company has independent bank accounts and has made independent tax registrations and has employed a team of accounting personnel independent from that of the Parent Company to conduct the accounting for the Group and all essential administrative functions are being and will be carried out independently by the Group without the need of support from the Parent Company.

Continuing transactions with the Parent Company

Although the Group will continue to have various continuing transactions with the Parent Company and CSR, such transactions are entered into in the ordinary and usual course of business of the Group and/or on normal commercial terms. The details of such connected transactions are set out in the paragraph headed “Connected Transactions” below.

CONNECTED TRANSACTIONS

Pursuant to Chapter 14A of the Listing Rules, substantial shareholders, promoters, directors, supervisors and chief executive officers of the Company or its subsidiaries, any person who was a director of the Company or its subsidiaries within 12 months preceding the date of listing of the Company’s H Shares on the Stock Exchange, and any of their respective associates will constitute a connected person. Upon the listing of the Company’s H Shares on the Stock Exchange, certain transactions the Group conducted with such connected persons will constitute connected transactions under Chapter 14A of the Listing Rules.

The Group has historically entered into various transactions with the Parent Company, CSR and its associates, Kunming China Railway, Shiling, ZELC and NERCC, certain of which the Group expects to continue following the Company’s listing. The Parent Company is the Company’s substantial shareholder and promoter. CSR is the holding company of the Parent Company and is therefore an associate of the Parent Company. Kunming China Railway and ZELC are promoters of the Company. Shiling is an associate of the Parent Company as the Parent Company owns a 50% equity interest in Shiling. NERCC is a wholly-owned subsidiary of the Parent Company and therefore an associate of the Parent Company. Following the listing of the Company’s H Shares on the Stock Exchange, the Parent Company, CSR, Kunming China Railway, Shiling, ZELC and NERCC will constitute connected persons, and the transactions the Group conduct with them will constitute continuing connected transactions pursuant to the Listing Rules.

(a) **The following continuing connected transactions are exempted from the independent shareholders' approval requirement, but are subject to the reporting and announcement requirements under Rule 14A.34 of the Listing Rules**

(i) *Lease of property and equipment by the Parent Company from the Company*

On 29 March 2006, the Company as a lessor and the Parent Company as a lessee entered into a property and equipment leasing agreement (the "First Lease Agreement") under which the Company agreed to let to the Parent Company four floors of the research administrative building of the Company with a total area of 6,960 sq.m. in Zhuzhou, the PRC at an annual rental of approximately RMB1.9 million (inclusive of utilities charges) with effect as from 1 January 2006 and ending on 31 December 2008 for office and other ancillary uses. The rent is determined with reference to the prevailing local market rate by reference to the prevailing market rent of offices in the city centre of Zhuzhou. Knight Frank Petty Ltd., an independent property valuer, has confirmed that the rental payable under the First Lease Agreement is not less than the prevailing local market rate.

The Company has received rental payments of approximately RMB0.9 million under the First Lease Agreement during the six-month period ended 30 June 2006.

(ii) *Lease of equipment by the Company from the Parent Company*

The Parent Company as a lessor and the Company as a lessee entered into an equipment leasing agreement on 25 March 2006 and a supplemental equipment leasing agreement on 30 May 2006 (together the "Second Lease Agreement") under which the Parent Company agreed to let to the Company certain testing equipment situated at the laboratories of the Parent Company in Zhuzhou for the Company's experiment and product testing uses. Pursuant to the leasing agreement dated 25 March 2006, the Company will pay an annual rental of approximately RMB9.0 million to the Parent Company starting from 1 January 2006 and ending on 31 December 2008. Pursuant to the supplemental equipment leasing agreement dated 30 May 2006, the leasing agreement would apply retroactively to (i) the period from 30 September 2004 to 30 September 2005, for which a rental of approximately RMB9.7 million (equal to the actual depreciation cost of the equipment) is payable and (ii) the period from 1 October 2005 to 31 December 2005, for which a rental of approximately RMB2.3 million is payable.

Historical rent paid by the Company under the Second Lease Agreement was approximately RMB3.03 million for the period from 30 September 2004 to 31 December 2004, approximately RMB9.00 million for the year ended 31 December 2005 and approximately RMB4.51 million for the six-month period ended 30 June 2006. The rent is determined with reference to the estimated market required rate of return for plant and machinery. Knight Frank Petty Ltd., an independent property valuer, has confirmed that the rental payable under the Second Lease Agreement is comparable to the estimated market required rate of return for plant and machinery.

(b) The following continuing connected transactions are subject to the reporting, announcement and the independent shareholders' approval requirements under Rule 14A.35(3) and (4) of the Listing Rules

(i) *Provision of general services by the Parent Company to the Group*

On 4 December 2006, the Parent Company and the Company entered into a general services agreement (the "General Services Agreement") under which the Parent Company agreed to provide general services to members of the Group for a period commencing on the date of the listing of the H Shares on the Stock Exchange and ending on 31 December 2008. The general services under the General Services Agreement involve the provision of catering services, accommodation, conference rooms and transportation for the Group. The price for the general services provided by the Parent Company to the Company will be determined on the following basis in the order of priority:

- the price prescribed by the state (including any price prescribed by any relevant local government, 國家指定價), if applicable;
- the price recommended under the state pricing guidelines (國家指導價), when no state-prescribed price is available;
- the market price, when neither a state-prescribed price nor a state recommended price is available; or
- the price which is no less favourable to the Group than is available to or from independent third parties, when none of the above is available or applicable.

For the three years ended 31 December 2003, 2004 and 2005 and the six-month period ended 30 June 2006, fees paid to the Parent Company by the Group amounted to approximately RMB3.80 million, RMB4.44 million, RMB6.48 million and RMB2.90 million, respectively. The substantial increase in the fees from 2004 to 2005 was primarily due to the fact that the Company started to subcontract to the Parent Company the transportation of the Group's personnel and business associates for the Group's business in early 2005.

The proposed annual value of the above transactions will not exceed RMB8.1 million, RMB10.1 million and RMB12.7 million for the three financial years ending 31 December 2006, 2007, and 2008, respectively, (the "General Services Caps"). The General Services Caps are determined with reference to the historical transaction amount in 2005 and an estimated annual increase of approximately 25% to meet the increasing demand of the Group in connection with its business growth.

(ii) *Mutual supply of products between the Parent Group and the Company*

On 4 December 2006, the Parent Company and the Company entered into a mutual supply agreement (the “First Mutual Supply Agreement”) under which the Company agreed to supply and procure its subsidiaries to supply to the Parent Company certain electrical parts and components (including power semiconductors, sensors, PCB assemblies, control system components and converters and related components) for the production of the Parent Company’s products and the Parent Company also agreed to supply and procure its subsidiaries to supply to the Group certain mechanical and electro-mechanical parts and components (including reactors and heat sinks) for the production of the Group’s train-borne electrical systems for a term commencing on the date of the listing of the H Shares on the Stock Exchange and ending on 31 December 2008.

The price for the parts and components supplied by and/to the Parent Group and the Group will be determined on the following basis in the order of priority:

- the price prescribed by the state (including any price prescribed by any relevant local government, 國家指定價), if applicable;
- the price recommended under the state pricing guidelines (國家指導價), when no state-prescribed price is available;
- the market price, when neither the state-prescribed price nor the state recommended price is available; or
- the price which is no less favourable to the Group than is available to or from independent third parties, when none of the above is available or applicable.

The Group and the Parent Group have historically entered into and will continue to have various transactions:

- (a) Before the Company obtained the import and export license in November 2005, the Group’s purchases from foreign suppliers and sales to foreign customers were conducted through the Parent Company and the related purchases and sales were accounted for as transactions between the Group and the Parent Company. After the Company obtained the import and export license, the Group has dealt directly with foreign customers and suppliers. However, certain procurement and sales contracts signed before November 2005 were to be completed by 2006. Under those subsisting contracts, during the year ended 31 December 2006, the sales from the Group to the Parent Company are estimated to be approximately RMB4.9 million and the purchases of the Company from the Parent Company are estimated to be approximately RMB96.8 million.
- (b) The Group has supplied and will continue to supply electrical parts and components to the Parent Company for the production of its products. The Parent Group has supplied and will continue to supply mechanical and electro-mechanical parts and components to the Group for its production of train-borne electrical systems.

RELATIONSHIP WITH THE PARENT COMPANY AND CONNECTED TRANSACTIONS

For the three years ended 31 December 2003, 2004 and 2005 and the six-month period ended 30 June 2006, fees paid to the Parent Group by the Group under the First Mutual supply Agreement amounted to approximately RMB22.5 million, RMB38.7 million, RMB62.9 million and RMB52.4 million, respectively, fees paid to the Group by the Parent Group under the First Mutual supply Agreement amounted to approximately RMB19.0 million, RMB9.9 million, RMB48.0 million and RMB24.2 million, respectively.

For the parts and components it currently procures from the Parent Group, the Group can procure them from independent third parties. The Group procures them from the Parent Group because it considers it to be in the Group's benefit for the following reasons:

- (i) the terms of the Group's purchases from the Parent Group are not less favourable than those the Group can obtain from independent third parties;
- (ii) the Parent Group is familiar with the standards and specifications of the Group with respect to the parts and components it needs; and
- (iii) the Parent Group is in close proximity with the Group, which will save transportation and packaging costs and facilitate a shorter lead time for orders and a lower level of the Group's inventories of relevant parts and components.

The proposed annual value of the products supplied by the Parent Group to the Group will not exceed RMB169.3 million, RMB79.7 million and RMB87.7 million for the three financial years ending 31 December 2006, 2007, and 2008, respectively; and the proposed annual value of the products supplied by the Group to the Parent Group will not exceed RMB54.9 million, RMB55.0 million and RMB60.0 million for the three financial years ending 31 December 2006, 2007, and 2008, respectively. (together the "First Mutual Supply Caps"). The First Mutual Supply Caps are determined with reference to (i) the historical transaction amounts, (ii) the outstanding transaction amounts under the subsisting contracts that were signed before the Company obtained the import and export license and (iii) an estimated annual increase of approximately 10% for the fees payable to the Parent Group by the Group (excluding the amount under (ii)) and an estimated annual increase of approximately 10% for the fees payable to the Group by the Parent Group (excluding the amount under (ii)). The 10% annual increase rate for the fees payable to the Parent Group by the Group was primarily based on the average annual increase rate of the MOR's procurement of new rail vehicles between 2000 and 2004, which was approximately 10.8%. The 10% annual increase rate for the fees payable to the Group by the Parent Group was primarily based on the PRC's average annual nominal GDP growth rate of 10.8% between 1999 and 2004, as the Parent Group's customers span a number of industries.

It is expected that the market for the electric vehicles the Parent Company manufactures and the medium to high voltage converters for industrial application NERCC manufactures will expand in the future.

(iii) *Mutual supply of products between CSR and the Company*

On 4 December 2006, CSR and the Company entered into a mutual supply agreement (the “Second Mutual Supply Agreement”) under which the Company agreed to supply and procure its subsidiaries to supply train-borne electrical systems and electrical components to CSR Group (excluding the Parent Group) and CSR also agreed to supply and procure its subsidiaries (excluding the Parent Company and its subsidiaries) to supply to the Group certain parts and components (including motors) for the Group’s production of train-borne electrical systems for a term commencing on the date of the listing of the H Shares on the Stock Exchange and ending on 31 December 2008.

The price for the parts and components supplied by and/to the CSR Group (excluding the Parent Group) and the Group will be determined on the following basis in the order of priority:

- the price prescribed by the state (including any price prescribed by any relevant local government, 國家指定價), if applicable;
- the price recommended under the state pricing guidelines (國家指導價), when no state-prescribed price is available;
- the market price, when neither the state-prescribed price nor the state recommended price is available; or
- the price which is no less favourable to the Group than is available to or from independent third parties, when none of the above is available or applicable.

For the three years ended 31 December 2003, 2004 and 2005 and the six-month period ended 30 June 2006, fees paid to the CSR Group (excluding the Parent Group) by the Group amounted to approximately RMB12.3 million, RMB25.9 million, RMB28.4 million and RMB12.3 million, respectively.

For the three years ended 31 December 2003, 2004 and 2005 and the six-month period ended 30 June 2006, fees paid to the Group by the CSR Group (excluding the Parent Group) amounted to approximately RMB186.3 million, RMB234.3 million, RMB207.7 million and RMB127.3 million, respectively.

For the parts and components it currently procures from the CSR Group, the Group can procure them from independent third parties. The Group procures them from the Parent Group because it considers it to be in the Group’s benefit for the following reasons:

- (i) the terms of the Group’s purchases from the CSR Group are not less favourable than those the Group can obtain from independent third parties; and
- (ii) due to long business relationships, the CSR Group is familiar with the standards and specifications of the Group with respect to the parts and components it needs.

RELATIONSHIP WITH THE PARENT COMPANY AND CONNECTED TRANSACTIONS

The proposed annual value of the products supplied by the CSR Group (excluding the Parent Group) to the Group under the Second Mutual Supply Agreement will not exceed RMB31.0 million, RMB34.1 million and RMB37.5 million for the three financial years ending 31 December 2006, 2007 and 2008, respectively. Such caps are determined with reference to the historical transaction amounts and an estimated annual increase of 10% primarily based on the average annual increase rate of the MOR's procurement of new rail vehicles between 2000 and 2004, which was 10.8%.

The proposed annual value of the products supplied by the Group to the CSR Group (excluding the Parent Group) will not exceed RMB450.0 million, RMB675.1 million and RMB806.1 million for the three financial years ending 31 December 2006, 2007 and 2008, respectively. Such caps are determined with reference to (i) the historical transaction amounts, (ii) the Group's committed supply of train-borne electrical systems to a member of the CSR Group in connection with the 200 km/h EMUs project in the amount of RMB172.2 million and RMB221.2 million for the financial years ending 31 December 2006 and 2007, respectively and (iii) the Group's supply of train-borne electrical systems to a member of CSR Group in connection with the 300 km/h EMUs in the amount of RMB176.1 million and RMB528.3 million for the financial years ending 31 December 2007 and 2008, respectively.

(iv) *Mutual supply of products between Kunming China Railway and the Company*

On 4 December 2006, Kunming China Railway and the Company entered into a mutual supply agreement (the "Third Mutual Supply Agreement") under which the Company agreed to supply and procure its subsidiaries to supply certain electrical control systems for large railway maintenance vehicles to Kunming China Railway and its subsidiaries (together the "Kunming China Railway Group") and Kunming China Railway also agreed to supply and procure its subsidiaries and associates to supply certain parts and components in relation to large railway maintenance vehicles to the Group for a term commencing on the date of the listing of the H Shares on the Stock Exchange and ending on 31 December 2008. The products that the Group would purchase from Kunming China Railway under the Third Mutual Supply Agreement are principally imported parts and components for the production of control systems for large railway maintenance vehicles.

Kunming China Railway, as licensee, entered into a technology license agreement with a European Company, as licensor, in relation to the license of the technology for large railway maintenance vehicles. As part of the consideration for the technology license, Kunming China Railway agreed to procure parts and components from the licensor in an amount equal to a fixed percent of its sales income from certain types of large railway maintenance vehicles ("procurement percentage"). Kunming China Railway has in turn formed a consortium with the Parent Company (implemented by the Group) and three other companies to manufacture large railway maintenance vehicles. With respect to each type of large railway maintenance vehicle, the parties would agree on what percentage they will each receive from the sales income ("revenue percentage"). For the type of product Kunming China Railway is obligated to procure parts and components from the licensor, each party of the consortium would also be obligated to procure parts and components from the licensor (through Kunming China Railway) in an amount equal to the sales income from relevant type of products multiplied by procurement percentage and revenue percentage.

RELATIONSHIP WITH THE PARENT COMPANY AND CONNECTED TRANSACTIONS

In addition to the Group's mandatory procurement of parts and components, to a lesser extent, the Group also procured certain custom made parts and components from the licensor through Kunming China Railway.

For the three years ended 31 December 2003, 2004 and 2005 and the six-month period ended 30 June 2006, fees paid to the Kunming China Railway Group by the Group amounted to approximately nil, RMB2.4 million, RMB36.4 million and RMB23.3 million, respectively.

For the three years ended 31 December 2003, 2004 and 2005 and the six-month period ended 30 June 2006, fees paid to the Group by the Kunming China Railway Group amounted to approximately nil, RMB31.8 million, RMB133.8 million and RMB73.6 million, respectively.

The proposed annual value of the products supplied by Kunming China Railway Group to the Group will not exceed RMB50.0 million, RMB61.0 million and RMB74.4 million for the three financial years ending 31 December 2006, 2007, and 2008, respectively; and the proposed annual value of the products supplied by the Group to Kunming China Railway Group will not exceed RMB160.0 million, RMB192.0 million and RMB230.4 million for the three financial years ending 31 December 2006, 2007, and 2008, respectively (the "Third Mutual Supply Caps"). The Third Mutual Supply Caps are determined with reference to the historical transaction amounts and an estimated annual increase of approximately 20% for the sales to Kunming China Railway Group by the Group and an estimated annual increase of approximately 22% for the sales to the Group by the Kunming China Railway Group for the three years ending 31 December 2008. The estimated annual increase rates of 20% and 22% were primarily based on the average annual increase rate of the Group's sales to the Kunming China Railway Group, which was 22.8%.

(v) *Transactions with Shiling*

Since the beginning of 2006, the Group has (A) procured certain imported electrical parts and components and (B) obtained OEM and packaging services from Shiling in connection with the 200 km/h EMU project and certain urban railway projects. Under the subsisting contracts, the Company's purchases from Shiling are estimated to be approximately RMB80.7 million and RMB118.3 million for the years ended 31 December 2006 and 2007, respectively. As the Company expects to complete its acquisition of 50% equity interest in Shiling by the end of 2007, Shiling will cease to be a connected person starting from 2008 and there will be no connected transactions between the Group and Shiling.

Based on the outstanding amount under the subsisting contracts, the proposed annual value of the Group's above transactions with Shiling will not exceed RMB85.0 million and RMB125.0 million for the years ended 31 December 2006 and 2007 respectively.

(c) **Waivers from the Stock Exchange in respect of the continuing connected transactions**

As the annual transactional amounts for each of the First Lease Agreement and the Second Lease Agreement is more than 0.1% but less than 2.5% for each of the percentage ratios (other than the profits ratio), the transactions under the First Lease Agreement and the Second Lease

RELATIONSHIP WITH THE PARENT COMPANY AND CONNECTED TRANSACTIONS

Agreement (the “Exempt Transactions”) constitute continuing connected transactions for the Company under Rule 14A.34 of the Listing Rules and are subject to the reporting and announcement requirements set out in Rule 14A.35(3) of the Listing Rules following the Proposed Listing.

As the annual transactional amounts for each of the General Services Agreement, the First Mutual Supply Agreement, the Second Mutual Supply Agreement and the Third Mutual Supply Agreement is more than 2.5% for each of the percentage ratios (other than the profits ratio), the transactions under the General Services Agreement, the First Mutual Supply Agreement, the Second Mutual Supply Agreement and the Third Mutual Supply Agreement (the “Non-Exempt Transactions”) constitute continuing connected transactions for the Company and are subject to the reporting, announcement and the independent shareholders’ approval requirements set out in Rule 14A.35(3) and (4) of the Listing Rules following the Proposed Listing.

The Exempt Transactions and the Non-Exempt Transactions will be entered into and conducted in the ordinary and usual course of business of the Group on normal commercial terms and on arm’s length basis in accordance with the pricing bases as set out in the relevant written agreements between the connected parties as mentioned above.

Pursuant to Rule 14A.42(3) of the Listing Rules, the Company has applied for, and the Stock Exchange has agreed to grant (i) a waiver from strict compliance with the announcement requirement under Rule 14A.47 of the Listing Rules in respect of the Exempt Transactions; and (ii) a waiver from strict compliance with the announcement requirement under Rule 14A.47 of the Listing Rules and the independent shareholders’ approval requirement under Rule 14A.48 of the Listing Rules in respect of the Non-Exempt Transactions.

The aggregate annual amounts of the Exempt Transactions and the Non-Exempt Transactions for the three financial years ending 31 December 2006, 2007 and 2008 shall not exceed the following annual caps:

<u>Type of transaction</u>	Annual cap for the financial year ending 31 December		
	2006	2007	2008
	<i>(RMB millions)</i>		
Exempt Transactions			
— First Lease Agreement <i>(Note 1)</i>	1.9	1.9	1.9
— Second Lease Agreement <i>(Note 2)</i>	9.0	9.0	9.0
Non-Exempt Transactions			
— General Services Agreement <i>(Note 3)</i>	8.1	10.1	12.7
— First Mutual Supply Agreement <i>(Note 4)</i>			
(i) Amount payable by the Company to the Parent Company for the mutual supply services provided by the Parent Group	169.3	79.7	87.7
(ii) Amount payable by the Parent Company to the Company for the mutual supply services provided by the Group	54.9	55.0	60.0

RELATIONSHIP WITH THE PARENT COMPANY AND CONNECTED TRANSACTIONS

<u>Type of transaction</u>	Annual cap for the financial year ending 31 December		
	2006	2007	2008
	<i>(RMB millions)</i>		
— Second Mutual Supply Agreement (<i>Note 5</i>)			
(i) Amount payable by the Company to CSR for the mutual supply services provided by the CSR Group	31.0	34.1	37.5
(ii) Amount payable by CSR to the Company for the mutual supply services provided by the Group	450.0	675.1	806.1
— Third Mutual Supply Agreement (<i>Note 6</i>)			
(i) Amount payable by the Company to Kunming China Railway for the mutual supply services provided by the Kunming China Railway Group	50.0	61.0	74.4
(ii) Amount payable by Kunming China Railway to the Company for the mutual supply services provided by the Group	160.0	192.0	230.4
— Transactions with Shiling (<i>Note 7</i>)	85.0	125.0	N/A

Notes:

- (1) The proposed caps for transactions under the First Lease Agreement are based on the prevailing local market rate by reference to the prevailing market rent of offices in Zhuzhou and taking into consideration the location of the property.
- (2) The proposed caps for transactions under the Second Lease Agreement are based on the estimated market required rate of return of the equipment.
- (3) The proposed caps for transactions under the General Services Agreement are based on the (a) the historical amounts of the relevant transactions between the Parent Company and the Group; and (b) the Group's estimated growth in demand for such general services from the Parent Company.
- (4) The proposed caps for transactions under the First Mutual Supply Agreement are based on the (a) the historical amounts of the relevant transactions between the Parent Group and the Group during the Track Record Period; and (b) the projected growth in the purchases and sales of parts and components of the Parent Group and the Group.
- (5) The proposed caps for transactions under the Second Mutual Supply Agreement are based on (a) the historical amounts of the relevant transactions between CSR Group and the Group during the Track Record Period; and (b) the projected growth in the purchases and sales of parts and components of the Group and the CSR Group.
- (6) The proposed caps for transactions under the Third Mutual Supply Agreement are based on (a) the historical amounts of the relevant transactions between Kunming China Railway Group and the Group during the Track Record Period; and (b) the projected growth in the purchases and sales of parts and components of the Kunming China Railway Group and the Group.
- (7) The proposed caps for transactions with Shiling are based on the amount under the subsisting contracts in connection with the 200 km/h EMU project and certain urban railway projects.

RELATIONSHIP WITH THE PARENT COMPANY AND CONNECTED TRANSACTIONS

The Company will comply with the provisions in Chapter 14A of the Listing rules governing continuing connected transactions from time to time.

The Directors (including the independent non-executive Directors) confirm that all of the above-mentioned continuing connected transactions were entered into on normal commercial terms and in the ordinary and usual course of business, and are fair and reasonable to the Group and are in the interests of the Shareholders as a whole.

The Joint Sponsors have reviewed relevant documentation, information and historical data provided by the Company and have participated in due diligence and discussions among the advisers of the Company and the Company and have considered representations and confirmation from the Company to satisfy themselves of the reliability of the information provided in relation to the connected transactions described above. The Joint Sponsors are of the view that (i) the terms of the agreements in relation to the connected transactions referred to in this section were entered into on normal commercial terms and in the ordinary and usual course of business of the Group and are fair and reasonable and are in the interests of the Company and its shareholders as a whole and (ii) that the proposed annual caps for these continuing connected transactions referred to above are fair and reasonable.

(d) The following continuing connected transactions are exempted from the independent shareholders' approval and announcement requirements under Rule 14A.33(3) of the Listing Rules

(i) Lease of property and equipment by the Company from ZELC

On 1 January 2005, ZELC as a lessor and the Company as a lessee entered into a property and equipment leasing agreement (the "Third Lease Agreement") under which ZELC agreed to let to the Company certain premises located at the testing workshop of the production area of ZELC of a total area of 4,779.18 sq.m. and the related gantry crane situated at the premises of ZELC in Zhuzhou, the PRC for a term of three years commencing from 1 January 2005 and ending on 31 December 2007 at an annual rental of approximately RMB126,700 (exclusive of management fees and utilities charges) for production use. The rent is determined with reference to the prevailing local market rent.

As the annual rent payable under the Third Lease Agreement is less than 0.1% of each of the applicable ratios (other than the profit ratio) of the Company, the Third Lease Agreement is exempted from the reporting, announcement and independent shareholders' approval requirements in accordance with Rule 14A.33(a) of the Listing Rules.

Rent paid for the year ended 31 December 2005 and the six months ended 30 June 2006 were RMB126,700 and RMB63,350, respectively. Knight Frank Petty Ltd. has confirmed that the rental payable under the Third Lease Agreement is not higher than the prevailing local market rental. The Directors (including the independent non-executive Directors) and the Joint Sponsors have confirmed that the transactions under the Third Lease Agreement are on normal commercial terms which are fair and reasonable and in the interests of the Company and Shareholders as a whole.

(ii) *Lease of property by NERCC from Times Electronics*

On 28 July 2006, Times Electronics as a lessor and NERCC as a lessee entered into a property leasing agreement (the “Fourth Lease Agreement”) under which Times Electronics agreed to let to NERCC an area of approximately 3,116 square meters at the factory of Times Electronics for a term of six months from 1 July 2006 to 31 December 2006 at a total rental of RMB175,000. The rent is determined with reference to the prevailing local market rent. As the annual rent payable under the Fourth Lease Agreement is less than 0.1% of each of the applicable ratios (other than the profit ratio) of the Company, the Fourth Lease Agreement is exempted from the reporting, announcement and independent shareholders’ approval requirements in accordance with Rule 14A.33(a) of the Listing Rules.

The lease is for a short term to meet NERCC’s requirements and there is no historical transactional amount associated with this lease. It is unlikely that this lease will need to be renewed upon its expiry. Knight Frank Petty Ltd. has confirmed that the rental payable under the Fourth Lease Agreement is comparable to the prevailing local market rental. The Directors (including the independent non-executive Directors) and the Joint Sponsors have confirmed that the transactions under the lease were entered into on normal commercial terms which are fair and reasonable and in the interests of the Company and its shareholders as a whole.

(iii) *Trademark licence arrangement between the Parent Company and the Company*

On 20 January 2006, the Parent Company, as the licensor, and the Company, as the licensee, entered into a trademark licence agreement (the “Trademark Licence Agreement”) under which the Parent Company agreed to grant a non-exclusive licence to the Company and its subsidiaries to use “TEG & device” marks registered in its name in the PRC under classes 7, 9, 12 and 32, being trademarks currently used by the Group for an annual licence fee of RMB10,000 for a period up to the validity period from 2012 to 2015 (subject to renewal) of the respective marks with effect from 1 January 2006. The Parent Company has agreed to maintain the registration of the trademarks in the PRC for the term of the licence. It has also agreed to apply for, at the Company’s request, the registration of the trademarks in such other jurisdictions and to license to the Group any trademarks already registered under the name of the Parent Company in other jurisdictions.

Further particulars of the Trademark Licence Agreement are set out in Appendix VIII.

The trademarks referred to above are not injected into the Group because the same trademarks will need to be used by the Parent Group and also in relation to businesses which are different from the Group’s businesses.

Each of the percentage ratios (other than profits ratio) under Chapter 14 of the Listing Rules, where applicable, in respect of the continuing connected transactions to be conducted under each of the Third Lease Agreement, the Fourth Lease Agreement and the Trademark Licence Agreement is, on an annual basis, expected to be less than 0.1%, the transactions under each of the Third Lease Agreement, the Fourth Lease Agreement and the Trademark Licence Agreement will constitute continuing connected transactions for the Company and fall under Rule 14A.33(3)(b) of the Listing Rules. They will be exempted from the announcement and independent shareholders’ approval requirements set out in Rules 14A.45 to 14A.48 of the Listing Rules.

The Directors (including five independent non-executive Directors) consider that the transactions contemplated under the Third Lease Agreement, the Fourth Lease Agreement and the Trademark Licence Agreement are on normal commercial terms, and are fair, reasonable and in the interests of the shareholders as a whole.

Related party transactions

In addition to those related party transactions which also constitute connected transactions, the Group has other related party transactions which have been disclosed in Appendix I to this prospectus. In the opinion of the Directors, all of the other related party transactions for each of the three years ended 31 December 2005 and the six months ended 30 June 2006 were conducted on an arm's length basis under normal commercial terms.

Protection of minority shareholders' interests

The Company is of the view that the interests of its independent shareholders will be adequately protected with the following measures being added to the corporate governance of the Company which will be adopted upon the listing of the H Shares of the Company on the Stock Exchange:

- (i) Interested Directors will declare their respective interests and will abstain from attending the board meeting sessions and voting in respect of the connected transactions they are interested in. As a result, Mr. Liao and Mr. Tian will abstain from attending the board meeting sessions and voting in respect of the connected transactions between the Company and the Parent Company or CSR, Mr. Ma Yunkun will abstain from attending the board meeting sessions and voting in respect of the connected transactions between the Company and Kunming China Railway.
- (ii) The Group has an independent professional management team responsible for negotiating and reviewing the terms in respect of its transactions with its suppliers and customers, including the Parent Group and CSR Group. Such management team consists of staff of the Group who possess relevant technology and sales expertise and the terms of references of such management team ensure that it is capable of making independent business judgments. The management team reports to the Board, which is responsible to the Company's shareholders as a whole.
- (iii) The independent non-executive Directors will be provided with a report by the auditors of the Company on all the transactions conducted between the Company and the Parent Group/CSR Group/Kunming China Railway on a quarterly basis, and the content of such report will be in compliance with the requirements under Rule 14A.38 of the Listing Rules.
- (iv) When making purchases, the Group will endeavour to obtain bids or quotes from a number of independent suppliers and select the successful bid, if applicable, based on objective standards such as price and quality of products, delivery schedule and services.

RELATIONSHIP WITH THE PARENT COMPANY AND CONNECTED TRANSACTIONS

- (v) Without prejudice to (i), the Company's board which is attended by all independent non-executive Directors will decide on whether the Group should proceed with a particular transaction with the Parent Group or the CSR Group.
- (vi) The terms of the supply and purchase arrangements between the Group and the Parent Group or CSR Group will be reviewed by independent non-executive Directors on a quarterly basis and the view in respect of those transactions will be disclosed to the shareholders by way of announcement. At the request of independent non-executive Directors, an independent individual who has at least 10 years of experience in the rail vehicle manufacturing industry may be engaged to assess the terms of the sales and purchase agreements and give their findings to independent non-executive directors.
- (vii) The Company's annual reports will contain summaries for the mechanisms in place in the relevant financial year and appropriate disclosure on how these mechanisms have operated during the same period.