

I. MANAGEMENT DISCUSSION AND ANALYSIS

The Company is one of the leading electric power generating equipment manufacturers in the PRC. The principal operations of the Company include hydro power generators, steam power generators, A.C. and D.C. electrical motors and controlling devices.

In 2006, all employees of the Company closely followed the Company's work directions and objectives for the year so that the Company overcame the difficulties in delivering products on a tight schedule and tight supply of raw materials. The Company's income from its principal business exceeded RMB 4 billion, and the production volume brought about by its power generating equipment surpassed 28,164MW. Economic operation was keeping track on a continuous and stable development trend.

In 2006, the Company achieved production of 49 sets/3,574MW of hydro power generators; 63 sets/24,590MW of steam power generators; 60 sets/176.37MW of A.C. motors; 37 sets/52.666MW of D.C. motors; and 259 sets of auxiliary machine equipment.

During the reporting period, the Company's operating results increased significantly due to the increase in production volume. In accordance with the HKFRS, the Company achieved a turnover of RMB4,698 million, representing an increase of 54.14% as compared with that of the previous year. Profit after tax amounted to RMB865 million, representing an increase of 61.70% over last year. Earnings per share amounted to RMB1.922, representing an increase of RMB 0.734 per share as compared with earnings per share of RMB1.188 in the previous year. In accordance with the PRC GAAP, the Company achieved sales income of RMB 4,698 million, representing an increase of 54.14% as compared with that of the previous year. Net profit amounted to RMB 830 million, representing an increase of 57.22% over that of last year. Earnings per share amounted to RMB 1.845, representing an increase of RMB 0.672 as compared with earnings per share of RMB1.173 in the previous year.

The Company achieved relatively good results in market development under the changing market landscape. The Company entered into contracts including four sets of 300MW pump storage hydro turbine generators in Hohhot Plant, three sets of 340MW hydro turbine generators in Jishixia Plant and two sets of 1,000MW ultra-supercritical turbine generators in Haimen Plant, four sets of 400MW steam turbine generators in Putian Plant, one set of 220MW all air-cooling turbine generators in Qianan Plant. The Company also obtained good results in exploring international market. The Company entered into contracts for two sets of 160MW hydro turbine generators in Vietnam Bonwei Plant, two sets of 43MW hydro turbine generators in Vietnam Bondusha Plant, two sets of 48.5MW hydro turbine generator in Vietnam Damen Plant and six sets of steam turbine generators in Indian Hasugu Plant. Among these, Bonwei Plant and Hasugu Plant are currently the hydro and thermal generating projects with the largest single power generating capacity exported from the PRC. The new order for the year amounted to RMB4,800 million.

II. PRINCIPAL OPERATIONS AND THE OPERATING STATUS

1. Principal operations by business and product

Unit: RMB'000

By business or products	Revenue from principal operations	Cost of principal operations	Principal operations' profit margin (%)	Increase/ (decrease) of revenue from principal operations as compared to last year (%)	Increase/ (decrease) of cost of principal operations as compared to last year (%)	Increase/ (decrease) of principal operations' profit margin as compared to last year (%)
By business						
Machinery manufacturing	4,698,079	3,378,189	28.09	54.14	61.28	A decrease of 3.19 percentage points
Including: connected transaction	418,490	334,810	20.00	118.63	85.91	An increase of 14.08 percentage points
By product						
Electric power-generating equipment	4,638,376	3,338,466	28.03	59.81	68.03	A decrease of 3.52 percentage points
Technological renovation, provision of services and others	59,703	39,723	33.47	-58.95	-63.15	An increase of 7.58 percentage points

2. Principal operations by region

Unit: RMB'000

By region	Revenue from principal operations	Increase/ (decrease) of revenue from principal operations as compared to last year (%)
The PRC	4,698,079	54.14

II. PRINCIPAL OPERATIONS AND THE OPERATING STATUS *(continued)*

3. Financial status (under PRC GAAP)

- (1) The Company's profit from principal operations for the year amounted to RMB1,309,562,000, representing an increase of 38.12% from RMB948,123,000 of last year, which was mainly attributable to a significant increase in sales revenue from principal operations.
- (2) The Company's profit from other operations for the year amounted to RMB72,230,000, representing an increase of 13.14% from RMB63,839,000 of last year, which was mainly attributable to a considerable increase in revenue from sales of waste and recycle materials.
- (3) Net profit of the Company for the year amounted to RMB830,200,000, representing an increase of 57.22% from RMB528,057,000 of last year, which was mainly attributable to: (i) an increase of RMB361,439,000 in profit from principal operations; and (ii) a reduction of RMB19,808,000 in financial cost resulting from the increase in interest of fixed deposits; an increase of RMB77,455,000 in operating expenses and administrative expenses.
- (4) The net increase in cash and cash equivalent for the year amounted to a deficit of RMB731,432,000, representing a decrease of 202.37% from RMB714,477,000 of last year, which was attributable to: (i) the considerable increase in cash paid for goods and services resulting from the increased production tasks; (ii) a sharp decrease in tax refund under three-tier preferential taxation policy; (iii) an increase in investment in fixed assets for further capacity expansion; and (iv) an increase of RMB171,000,000 in dividends paid for ordinary shares over the previous year.
- (5) Total assets of the Company for the year amounted to RMB9,629,820,000, representing an increase of 13.80% from RMB8,461,765,000 of last year, which was attributable to: (i) an increase of RMB549,445,000 in prepayment compared with last year resulting from the additional procurement of raw materials and outsourcing business in order to cater for the production and delivery need; (ii) an increase of RMB937,120,000 in inventories over that of last year due to the significantly increased reserve of raw materials and work in progress as a result of continuous growth in production tasks; and (iii) the substantial increase in long-term investment due to the third and fourth investments payable for Areva-Dongfang Reactor Coolant Pumps Company Limited pursuant to the joint venture agreement.
- (6) Total liabilities of the Company for the year amounted to RMB7,112,847,000, representing an increase of 7.33% from RMB6,627,080,000 of last year, which was mainly attributable to: A. the increase of RMB77,978,000 in notes payable over that of last year as a result of increased use of bank notes during the settlement period; B. the increase of RMB189,492,000 in accounts payable over that of last year as a result of the significantly increased purchase of raw materials.
- (7) Shareholders' equity of the Company for the year amounted to RMB2,515,189,000, representing an increase of 37.19% from RMB1,833,410,000 of last year, which was mainly attributable to the significant increase in net profit.
- (8) As at the end of 2006, the gearing ratio of the Company was 73.86%, decreased by 4.46 percentage points as compared with that at the end of the previous year.

II. PRINCIPAL OPERATIONS AND THE OPERATING STATUS *(continued)*

4. Financial status (prepared under HKFRS)

(1) Financial status

As at 31 December 2006, the current assets of the Company amounted to RMB8,786,083,000 (2005: RMB7,706,536,000). Items with relatively significant changes and the reasons are analysed as follows:

- 1) Cash and bank balances amounted to RMB3,277,378,000 (2005: RMB4,027,493,000), decreased by 18.62% over 2005, primarily attributable to the increased procurement of raw materials and subcontracting businesses.
- 2) Trade and other receivables amounted to RMB2,516,145,000 (2005: RMB1,623,534,000), increased by 54.98% as a result of A) increased trade receivables because of the increase in sales of the Company due to the favourable conditions in the electricity generating equipment market; B) significant increase in provisions for trade payables due to the increased procurement of raw materials and subcontracting businesses in the period for continuous growth of the Company's production.
- 3) Amounts due from the customers for contract works amounted to RMB 569,812,000 (2005: RMB 259,869,000), an increase of 119.27% from last year, mainly due to the significant increase in the investment for the Company's hydro power generating products.
- 4) Inventories amounted to RMB2,420,883,000 (2005: RMB1,794,023,000), 34.94% increase from last year, mainly due to the increased inventories of raw materials and investment in work-in-progress for the purpose of satisfying ever-growing production.

As at 31 December 2006, the current liabilities of the Company amounted to RMB7,149,981,000 (2005: RMB6,649,461,000). Items with relatively significant changes and the reasons are analyzed as follows:

- 1) Income tax payables amounted to RMB149,743,000 (2005: RMB87,456,000), 71.22% increase from last year, mainly due to significant increase in profit for the current period.
- 2) Other tax payables amounted to RMB73,064,000 (2005: RMB38,814,000), 88.24% increase from last year, mainly due to the increase in realised sales income for the current period, which led to a significant growth in value-added tax payable.
- 3) Provisions amounted to RMB38,045,000 (2005: Nil), mainly due to estimated losses from the insurance incurred from warranty of the main equipment with terms of 2 to 3 years terms.

II. PRINCIPAL OPERATIONS AND THE OPERATING STATUS *(continued)*

4. Financial status (prepared under HKFRS) *(continued)*

(2) Capital Structure

As at 31 December 2006, the equity-to-debt ratio of the Company was 311.81% (2005: 398.19%), dropped 86.38 percentage points as compared with that of last year. The decrease was mainly attributable to the increase in profit in last year, leading to a significant increase in the shareholders' interest. At present, the Company has no bank borrowings.

(3) Cash Flows

As at 31 December, 2006, the cash and cash equivalents of the Company recorded a net increase of RMB10,576,000 as compared with that of the last year (2005: net decrease of RMB751,098,000). The main items include investment for the year affected by the transfer of fixed deposits with maturity over three months to account deposits leading to cash inflow, amounting to RMB760,351,000. Operating net cash outflow amounted to RMB307,914,000, acquisition of fixed assets and intangible assets amounted to RMB202,468,000, and dividend payout of RMB225,000,000.

(4) Gearing Ratio

The total assets and total liability of the year amounted to RMB9,630,473,000 and RMB7,290,703,000 respectively. Accordingly, the gearing ratio was 75.70%, dropped 4.22 percentage points from 79.92% at last year-end.

(5) During the reporting period, the Company did not pledge any of its assets.

(6) The risk in fluctuation of exchange rate and any related hedging

The amount of deposit in foreign currency was minimal, therefore the Company was less susceptible to exchange rate fluctuation.

This year, the Company suffered loss from currency exchange which was mainly due to appreciation of Renminbi. The prepayment and trade payable of the Company's raw material procurement is subject to foreign exchange fluctuation. The currency exchange results in a new loss because the amount of prepayment denominated in foreign currencies is higher than trade payable denominated in foreign currencies.

(7) Contingent liabilities

As of the end of the period, the Company had incurred no contingent liability.

II. PRINCIPAL OPERATIONS AND THE OPERATING STATUS *(continued)*

5. Structure of assets (prepared under PRC GAAP)

Unit: RMB'000

Item	Amount		Percentage in the total assets (%)		
	2006	2005	2006	2005	Increase (decrease) %
Bills receivables	45,930	18,629	0.48	0.22	118.18
Accounts receivables	1,025,946	852,385	10.65	10.07	5.76
Other receivables	73,921	39,532	0.77	0.47	63.83
Prepayments	1,263,147	713,701	13.12	8.43	55.63
Inventories	2,990,695	2,053,574	31.06	24.27	27.98
Long-term equity investment	24,224	7,070	0.25	0.08	212.50
Fixed assets	693,790	569,034	7.20	6.72	7.14
Construction in progress	73,822	120,565	0.77	1.42	-45.77
Total assets	9,629,820	8,461,765			

- (1) The percentage of bills receivables in total assets for the year increased by 118.18% as compared with last year, mainly due to the increase in number of bills received during the collection of trade receivables;
- (2) The percentage of other receivables in total assets for the year increased by 63.83% as compared with last year, mainly due to the increase in interest accrued on fixed deposits at the end of reporting period;
- (3) The percentage of prepayments in total assets for the year increased by 55.63% as compared with last year, mainly due to the rise in deposit paid by the Company for the considerably increased procurement of raw materials and outsourcing business.
- (4) The percentage of inventories in total assets for the year increased by 27.98% as compared with last year, mainly due to the significantly increased reserve of raw materials and work in progress to cater for the long-term production arrangements need.
- (5) The percentage of long-term equity investment in total assets for the year increased by 212.50% as compared with last year, mainly due to the Company's contribution of RMB17,000,000 for the third and fourth investment on Areva-Dongfang Reactor Coolant Pumps Company Limited pursuant to the joint venture agreement.
- (6) The percentage of fixed assets in total assets for the year increased by 7.14% as compared with last year, mainly due to the newly invested fixed assets for further capacity expansion.

II. PRINCIPAL OPERATIONS AND THE OPERATING STATUS *(continued)*

6. Expenses for the period and income tax (prepared under PRC GAAP)

Unit: RMB'000

Item	2006	2005	Increase (decrease) %
Operating expenses	30,025	20,989	43.05
Management expenses	478,706	410,287	16.68
Financial expenses	(50,426)	(30,618)	-64.69
Income tax	94,234	82,213	14.62
Net cash flows from operating activities	(282,951)	1,009,103	-128.04
Net cash flows from investing activities	(216,292)	(181,348)	-19.27
Net cash flows from financing activities	(231,847)	(112,677)	-105.76

- (1) Operating expenses for the year increased by 43.05% as compared with last year, mainly due to the increase in business expenses, travelling expenses and personnel costs as a result of the considerable growth in the Company's marketing business with the accelerated exploration of domestic and overseas markets.
- (2) Management expenses for the year increased by 16.68% as compared with last year, mainly due to the considerable increase in technological development expenditures.
- (3) Financial expenses for the year decreased by 64.69% as compared with last year, mainly due to the increase in interest income from fixed deposits.
- (4) Income tax for the year increased by 14.62% as compared with last year, mainly due to the rise in profit.
- (5) Net cash flows from operating activities for the year decreased by 128.04% as compared with last year, mainly due to the significantly increased cash paid for goods and services as a result of substantial growth in production tasks, together with a sharp decrease in tax refund under three-tier preferential taxation policy.
- (6) Net cash flows from investing activities for the year decreased by 19.27% as compared with last year, mainly due to the increase in cash outflow from investing activities as a result of increased investment in fixed assets for further capacity expansion.
- (7) Net cash flows from financing activities for the year decreased by 105.76% as compared with last year, mainly due to a year-on-year increase of RMB171,000,000 in dividends paid for ordinary shares.

II. PRINCIPAL OPERATIONS AND THE OPERATING STATUS *(continued)*

7. Operating status and results of major holding companies (prepared under PRC GAAP)

Unit: RMB'000

Name	Nature of businesses	Major products and services	Registered capital	Total assets	Net profit
DFEM Control Equipment Company Limited	Manufacturing	Design, manufacture and sale of control equipment in relation to power generators and A.C and D.C. motors	13,000	274,880	8,673
DFEM Power Equipment Company Limited	Manufacturing	Design, manufacture and sale of Large and medium A.C. and D.C. motors, small hydro-power motors and specialised generators	42,754	46,162	122
DFEM Tooling and Moulding Company Limited	Manufacturing	Design, manufacture and sale of industrial tool and knife tool; process and sale of ordinary machinery and machinery accessories	14,600	44,916	711
DFEM Equipment Engineering Company Limited	Manufacturing	Overhaul of electrical machinery, technological transformation; installation and test run of complete set of electrical machinery; design, manufacture and sale of complete set of electrical machinery control system; environmental protection equipment; design, manufacture, installation and sale of special equipment etc.; manufacture and sale of machinery spare parts and general spare parts; technical consultancy and service for electrical machinery	13,500	28,420	478

8. Major suppliers and customers

Unit: RMB'000

Purchase from the top 5 suppliers	780,476	Percentage in the total purchase	22.42%
Sales to the top 5 customers	1,184,847	Percentage in the total sales	25.22%

III. INVESTMENT OF THE COMPANY

The investment of the Company during the reporting period amounted to RMB289,480,000, comprising mainly: basic construction with actual investment amounting to RMB116,070,000, technological renovation project with actual investment amounting to RMB131,800,000, renewal of equipment with actual investment amounting to RMB2,780,000, technology measures with actual investment amounting to RMB22,300,000, electronic and measuring equipment with actual investment amounting to RMB8,610,000 and renovation of equipment with actual investment amounting to RMB7,920,000. The completion of these projects enhanced the overall production and manufacturing capacity of the Company.

During the period, the Company had no proceeds raised during the year or funds brought forward from previous periods.

IV. REASON AND IMPACT OF CHANGES IN ACCOUNTING POLICIES, ACCOUNTING ESTIMATES OR CORRECTION TO MATERIAL ACCOUNTING ERRORS

During the reporting period, the Company had no changes in accounting policies or accounting estimates or correction to material accounting errors

V. DAILY MANAGEMENT BY THE BOARD

1. Board meetings and resolutions passed

- (1) The 2nd meeting of the fifth Board was held on 26 January 2006 for considering and approving the Company's 2006 administrative guidelines and objectives, fixed assets investment plan for 2006, The Board considered and approved Rules for Procedures of the Remuneration Committee of the Board of Directors of Dongfang Electrical Machinery Company Limited, Administrative Measures for Connected Transactions of Dongfang Electrical Machinery Company Limited and Administrative Systems of Investors Relationship of Dongfang Electrical Machinery Company Limited.
- (2) The 3rd meeting of the fifth Board was held on 20 April 2006 for considering and approving the 2005 financial statements of the Company, the 2005 profit after taxation distribution plan of the Company, the full text of 2005 annual report and its summary, the 2006 financial budget of the Company, the proposed appointment of accountants, proposal for connected transactions, the holding of the 2005 annual general meeting, and the first quarterly report of the Company for 2006.
- (3) The 4th meeting of the fifth Board was held on 22 August 2006 for considering and approving the proposal of the proposed write-off of relevant fixed assets, the unaudited interim financial statements for 2006, the interim profit appropriation plan for 2006, the interim report for 2006.
- (4) The 5th meeting of the fifth Board was held on 17 October 2006 for considering and approving the Company's third quarterly report for 2006.

2. Implementation of resolutions passed at general meetings by the Board

The Board of the Company has strictly implemented all resolutions passed at the general meeting during the reporting period and will continue to honestly and diligently serving the Company and its shareholders for their maximized interests.

VI. PROFIT DISTRIBUTION PLAN OR TRANSFER OF CAPITAL RESERVE TO SHARE CAPITAL

Upon consideration and approval at the 8th meeting of the fifth Board, the Board put forward the profit distribution plan for 2006, pursuant to which a cash dividend of RMB0.20 per share (A shares inclusive tax) shall be distributed. The matter will be submitted to the annual general meeting for consideration.

VII. THE CORPORATE PLAN FOR THE COMING YEAR

The Company will consolidate the core assets of power generation manufacturing equipment by acquiring the DEC owned equity interest in Dongfang Boiler and 100% equity interest of Dongfang Turbine Co., Ltd, to realize the listing of core assets of DEC. As a result, the complete set capacity of manufacturing power generation equipment will be strengthened and the overall competitiveness of the Company will be enhanced.

In respect of production, the Company will enter into a new peak season of production. The Company will tighten the control over production process, organize production plan in a more scientific and efficient way, improve the execution efficiency, fully utilize social resources, and ensure on-time delivery. Regarding marketing, the Company will pay attention to State policy of electricity development, as well as the market trend, keep tracks of major and key projects, for the purpose of securing more orders in the late term of "Eleventh Five-year" Plan. In relation to raw material supply, the Company will reinforce communication and coordination with casting and forging factories enhance the monitor of the contract enforcement. For equipments, the production capability of new key equipment and plants will be standardized as soon as possible to raise the overall equipment level of the Company and solve the bottlenecks in production. In respect of management, the Company will raise its efficacy, speed up momentum, apply creative thinking and creative work in order to raise overall efficacy of the enterprise, and achieve business objectives and mission.