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**If you have sold or transferred** all your shares in Shandong Molong Petroleum Machinery Company Limited, you should at once hand this circular together with the enclosed form of proxy to the purchaser or the transferee or to the bank, stockbroker or other agent through whom the sale or transfer was effected for transmission to the purchaser or the transferee.

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**山東墨龍石油機械股份有限公司**  
Shandong Molong Petroleum Machinery Company Limited

*(A Sino-foreign joint stock limited company incorporated in the People's Republic of China with limited liability)*

**(Stock Code: 8261)**

**CONTINUING CONNECTED TRANSACTIONS AND  
CONNECTED TRANSACTION**

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



**China Everbright Capital Limited**

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A letter from the Board is set out on pages 4 to 22 of this circular.

A letter from the Independent Board Committee is set out on page 23 of this circular.

A letter from China Everbright Capital Limited, the independent financial adviser, containing its advice to the Independent Board Committee and the Independent Shareholders is set out on pages 24 to 38 of this circular.

A notice convening the EGM of the Company to be convened and held at 3:00 p.m. on 28 November 2005 at No. 99 Beihai Road, Shouguang City, Shandong Province, the People's Republic of China is set out on pages 45 to 47 of this circular. Whether or not you are able to attend the above meeting, please complete and return the enclosed proxy form in accordance with the instructions printed thereon as soon as practicable and in any event by not less than 24 hours before the time appointed for the holding of the meeting or any adjournment thereof (as the case may be). Completion and return of the proxy form will not preclude you from attending and voting in person at the meeting or at any adjourned meeting (as the case may be) should you so wish.

This circular will remain on the GEM website at [www.hkgem.com](http://www.hkgem.com) on the "Latest Company Announcements" page for a minimum period of 7 days from the date of publication.

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## CHARACTERISTICS OF GEM

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**GEM has been established as a market designed to accommodate companies to which a high investment risk may be attached. In particular, companies may list on GEM with neither a track record of profitability nor any obligation to forecast future profitability. Furthermore, there may be risks arising out of the emerging nature of companies listed on GEM and the business sectors or countries in which the companies operate. Prospective investors should be aware of the potential risks of investing in such companies and should make the decision to invest only after due and careful consideration. The greater risk profile and other characteristics of GEM mean that it is a market more suited to professional and other sophisticated investors.**

**Given the emerging nature of companies listed on GEM, there is a risk that securities traded on GEM may be more susceptible to high market volatility than securities traded on the Main Board of the Stock Exchange and no assurance is given that there will be a liquid market in the securities traded on GEM.**

**The principal means of information dissemination on GEM is publication on the internet website operated by the Exchange. Listed companies are not generally required to issue paid announcements in gazetted newspapers. Accordingly, prospective investors should note that they need to have access to the GEM website in order to obtain up-to-date information on GEM-listed issuers.**

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## DEFINITIONS

“Annual Caps”	the proposed annual caps for the Continuing Connected Transactions as set out in pages 7 to 17 of this circular
“Board”	the board of directors of the Company
“Company”	山東墨龍石油機械股份有限公司 (Shandong Molong Petroleum Machinery Company Limited)
“Connected Transaction”	the transaction contemplated under the Machinery Accessories Supply Agreement
“Continuing Connected Transactions”	the transactions contemplated under the Oil Well Pipe and Casing Billets Supply Agreement, the Metallurgy Accessories Supply Agreement and the Scrap and Used Metals Supply Agreement
“Director(s)”	director(s) of the Company
“EGM”	extraordinary general meeting of the Company to be convened and held at 3:00 p.m. on 28 November 2005
“GEM”	the Growth Enterprise Market of The Stock Exchange of Hong Kong Limited
“GEM Listing Rules”	the Rules Governing the Listing of Securities on GEM
“Group”	the Company and its subsidiaries
“HK\$”	Hong Kong dollar, the lawful currency of Hong Kong
“Hong Kong”	the Hong Kong Special Administrative Region of the PRC
“Independent Board Committee”	an independent committee of the board of directors of the Company, comprising Mr. Qin Xue Chang, Mr. Yan Yi Zhuang and Mr. Loke Yu, the independent non-executive Directors
“Independent Shareholder(s)”	the shareholder(s) of the Company other than Mr. Zhang En Rong, Mr. Lin Fu Long, Mr. Zhang Yun San, Mr. Xie Xin Cang, Mr. Liu Yun Long and their respective associates
“Latest Practicable Date”	5 October 2005, being the latest practicable date prior to the printing of this circular for the purpose of ascertaining certain information referred to in this circular
“Machinery Accessories Supply Agreement”	an agreement entered into between the Company and Molong Equipment on 22 September 2005 in relation to the supply of machinery accessories to the Company by Molong Equipment

## DEFINITIONS

“Maolong Machinery”	壽光懋隆機械電氣有限公司 (Shouguang Maolong Machinery Company Limited), a limited liability company established in the PRC. The shareholders of Maolong Machinery are Zhang Zhi Jun (張志軍), Zhang Guang He (張光和), Zhang Jin Sheng (張錦生), Guo Huan Ran (國煥然), Ren Chun Qing (任春清), Li Bao Hui (李寶惠), Zhang Jin Chuan (張金川), Zhang Yun Qi (張雲起), Lin Fu Long (林福龍), Zhang Yun San (張雲三), Xie Xin Cang (謝新倉), Liu Yun Long (劉雲龍) and Cui Huan You (崔煥友), who are interested in 1.96%, 2.10%, 1.86%, 4.85%, 1.86%, 6.11%, 6.46%, 53.15%, 6.46%, 6.46%, 1.94%, 4.85% and 1.94% respectively of the registered capital of Maolong Machinery. Among the shareholders of Maolong Machinery, (i) Lin Fu Long (林福龍), Zhang Yun San (張雲三), Xie Xin Cang (謝新倉), Liu Yun Long (劉雲龍) and Cui Huan You (崔煥友) are also shareholders of the Company who are interested in 6.34%, 5.67%, 3.96%, 2.72% and 1.71% respectively of the registered capital of the Company; (ii) Lin Fu Long (林福龍), Zhang Yun San (張雲三) and Xie Xin Cang (謝新倉) are Directors; and (iii) Li Bao Hui (李寶惠) is the supervisor of the Company and the wife of Xie Xin Cang (謝新倉)
“Metallurgy Accessories Supply Agreement”	an agreement entered into between the Company and Molong Equipment on 22 September 2005 in relation to the supply of metallurgy accessories to the Company by Molong Equipment
“Molong Equipment”	壽光墨龍機電設備有限公司 (Shouguang Molong Electro-mechanical Equipment Company Limited), a sino-foreign joint venture established in the PRC in which Maolong Machinery and Mr. Fang is interested in 55% and 45% respectively of its registered capital. Mr. Fang is an independent third party
“Oil Well Pipe and Casing Billets Supply Agreement”	an agreement entered into between the Company and Weihai Baolong on 22 September 2005 in relation to the supply of oil well pipe and casing billets to the Company by Weihai Baolong
“PRC” or “China”	The People’s Republic of China and for the purpose of this circular excludes Hong Kong, Macau Special Administrative Region and Taiwan
“RMB”	Renminbi, the lawful currency of the PRC
“Scrap and Used Metals Supply Agreement”	an agreement entered into between the Company and Molong Equipment on 22 September 2005 in relation to the supply of scrap and used metals by the Company to Molong Equipment

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## DEFINITIONS

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“Shareholder(s)”	shareholder(s) of the Company
“Sponsor”	Deloitte & Touche Corporate Finance Ltd.
“Supervisor(s)”	supervisor(s) of the Company
“Stock Exchange”	The Stock Exchange of Hong Kong Limited
“Transactions”	the Continuing Connected Transactions and the Connected Transaction
“Weihai Baolong”	威海寶隆石油專材有限公司 (Weihai Baolong Special Petroleum Materials Co., Ltd.) (formerly known as 威海見龍鋼鐵有限公司 (Weihai Jianlong Iron & Steel Co., Ltd.))

*For the purpose of this circular, unless otherwise specified, conversion of RMB into HK\$ is based on the exchange rate of RMB1.04 = HK\$1.00.*

*For ease of reference, the names of the PRC-incorporated companies and entities have been included in this circular in both the Chinese and English languages. In the event of any inconsistency, the Chinese name prevails.*



# 山東墨龍石油機械股份有限公司

Shandong Molong Petroleum Machinery Company Limited

(A Sino-foreign joint stock limited company incorporated in the People's Republic of China with limited liability)

(Stock Code: 8261)

*Executive Directors:*

Zhang En Rong  
Lin Fu Long  
Zhang Yun San  
Xie Xin Cang

*Registered Office:*

No. 99 Beihai Road  
Shouguang City  
Shandong Province  
The People's Republic of China

*Non-executive Directors:*

Chen Jian Xiong  
Wang Ping

*Principal place of business*

*in Hong Kong:*  
Suite F, 10th Floor  
Ho Lee Commercial Building  
38-44 D'Aguilar Street  
Central, Hong Kong

*Independent Non-Executive Directors:*

Qin Xue Chang  
Yan Yi Zhuang  
Loke Yu alias Loke Hoi Lam

7 October 2005

*To the Shareholders*

Dear Sir/Madam,

## **CONTINUING CONNECTED TRANSACTIONS AND CONNECTED TRANSACTION**

### **1. INTRODUCTION**

#### **Continuing Connected Transactions**

On 22 September 2005, the Company and Weihai Baolong, a non wholly-owned subsidiary of Maolong Machinery, entered into an Oil Well Pipe and Casing Billets Supply Agreement for the supply of oil well pipe and casing billets from Weihai Baolong. Pursuant to the Oil Well Pipe and Casing Billets Supply Agreement, it has been agreed that the supply price of oil well pipe and casing billets charged by Weihai Baolong to the Company will be the then prevailing market price less an agreed discount of not more than RMB100/ton. The Oil Well Pipe and Casing Billets Supply Agreement shall become effective from the date of the EGM and remain in force up to 31 December 2007, subject to the approval of the Independent Shareholders at the EGM.

## LETTER FROM THE BOARD

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On 22 September 2005, the Company and Molong Equipment, a non wholly-owned subsidiary of Maolong Machinery, entered into a Metallurgy Accessories Supply Agreement for the supply of metallurgy accessories from Molong Equipment. Pursuant to the Metallurgy Accessories Supply Agreement, it has been agreed that the price at which metallurgy accessories are supplied to the Company by Molong Equipment will be at the fixed rates prescribed by the relevant authorities of the PRC (if any). If no fixed rates are prescribed by the relevant authorities of the PRC, the purchase price will be negotiated and agreed by both parties with reference to the then prevailing market price, subject to adjustments. The Metallurgy Accessories Supply Agreement shall become effective from the date of the EGM and remain in force up to 31 December 2007, subject to the approval of the Independent Shareholders at the EGM.

On 22 September 2005, the Company and Molong Equipment, a non wholly-owned subsidiary of Maolong Machinery, entered into a Scrap and Used Metals Supply Agreement for the sale of scrap and used metals by the Company to Molong Equipment. Pursuant to the Scrap and Used Metals Supply Agreement, it has been agreed that the price at which scrap and used metals are supplied by the Company to Molong Equipment will be at the fixed rates prescribed by the relevant authorities of the PRC (if any). If no fixed rates are prescribed by the relevant authorities of the PRC, the purchase price will be negotiated and agreed by both parties with reference to the then prevailing market price, subject to adjustments. The Scrap and Used Metals Supply Agreement shall become effective from the date of the EGM and remain in force up to 31 December 2007, subject to the approval of the Independent Shareholders at the EGM.

Zhang En Rong and Zhang Yun San are connected persons of the Company pursuant to Rule 20.11(1) of the GEM Listing Rules. Pursuant to Rule 20.11(4)(b) of the GEM Listing Rules, as Zhang Yun Qi is the son of Zhang En Rong and the brother of Zhang Yun San, he is regarded as the associate of the Directors and accordingly, is also a connected person of the Company. As Zhang Yun Qi is interested in approximately 53.15% of the equity interest in Maolong Machinery, Maolong Machinery is deemed to be a connected person of the Company.

Since Molong Equipment is a subsidiary of Maolong Machinery, Molong Equipment is also deemed to be a connected person of the Company.

According to the GEM Listing Rules, each of the transactions mentioned above will constitute a continuing connected transaction of the Company and will be subject to the requirements of reporting, announcement and independent shareholders' approval as required by Rules 20.45, 20.46, 20.47 and 20.48 of the GEM Listing Rules.

### **Connected Transaction**

On 22 September 2005, the Company and Molong Equipment, a non wholly-owned subsidiary of Maolong Machinery, entered into a Machinery Accessories Supply Agreement for the supply of machinery accessories from Molong Equipment. The total consideration payable by the Company to Molong Equipment for the supply of machinery accessories, pursuant to the Machinery Accessories Supply Agreement shall be approximately RMB33,000,000 (equivalent to approximately HK\$31,731,000) and will be settled in cash monthly in arrears. The Machinery Accessories Supply Agreement shall become effective from the approval of the Independent Shareholders at the EGM.



## LETTER FROM THE BOARD

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Since Molong Equipment is deemed to be a connected person of the Company, the transaction constitutes a connected transaction of the Company under Rule 20.13(1) of the GEM Listing Rules.

Approvals will be sought from the Independent Shareholders at the EGM in relation to the resolutions approving the Transactions and the Annual Caps. As such, Mr. Zhang En Rong, Mr. Lin Fu Long, Mr. Zhang Yun San, Mr. Xie Xin Cang, Mr. Liu Yun Long and their respective associates (as the case may be) holding approximately 58.7% of the equity interests in the Company will abstain from voting in respect of the above resolutions. Mr. Zhang En Rong, Mr. Lin Fu Long, Mr. Zhang Yun San, Mr. Xie Xin Cang and Mr. Liu Yun Long will abstain from voting in respect of the above resolutions because each of them, being the shareholders of the Company, is interested or is deemed to be interested in the equity interests of Maolong Machinery. Please refer to the definition of Maolong Machinery for their respective shareholdings in Maolong Machinery.

The purpose of this circular is (i) to provide you with further information in respect of the Transactions (including recommendations from the Independent Board Committee and opinion rendered from China Everbright Capital Limited) and (ii) to give you notice of the EGM at which ordinary resolutions will be proposed to seek the approval from the Independent Shareholders for the Transactions and the Annual Caps.

### 2. CONTINUING CONNECTED TRANSACTIONS

#### (i) The Oil Well Pipe and Casing Billets Supply Agreement

##### *Date of the Oil Well Pipe and Casing Billets Supply Agreement*

22 September 2005

##### *Parties to the Oil Well Pipe and Casing Billets Supply Agreement*

Purchaser: The Company is principally engaged in the design, manufacture and sale of petroleum extraction machinery and related accessories

Seller: Weihai Baolong, a non wholly-owned subsidiary of Maolong Machinery, is principally engaged in the sale and manufacture of special metallic materials for petroleum

##### *Oil well pipe and casing billets to be purchased*

Pursuant to the Oil Well Pipe and Casing Billets Supply Agreement, Weihai Baolong has agreed to sell and the Company has agreed to purchase oil well pipe and casing billets at the following terms:

Parties: Weihai Baolong as seller

The Company as purchaser

## LETTER FROM THE BOARD

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**Subject:** Pursuant to the Oil Well Pipe and Casing Billets Supply Agreement, Weihai Baolong has agreed to supply to the Company oil well pipe and casing billets.

**Term:** The Oil Well Pipe and Casing Billets Supply Agreement is effective from the date of the EGM to 31 December 2007 (both dates inclusive), subject to the approval of the Independent Shareholders at the EGM.

**Price:** Pursuant to the Oil Well Pipe and Casing Billets Supply Agreement, it has been agreed that the supply price of oil well pipe and casing billets charged by Weihai Baolong to the Company will be the prevailing market price less an agreed discount of not more than RMB100/ton. The above discount is determined as a result of the commercial negotiation between the Company and Weihai Baolong.

The current prevailing market price is approximately RMB3,800/ton and hence the supply price of oil well pipe and casing billets charged by Weihai Baolong to the Company has been agreed to be RMB3,700/ton (“**Oil Well Pipe and Casing Billets Supply Price**”).

**Historical figures:** There were no sales of oil well pipe and casing billets by Weihai Baolong to the Company up to the Latest Practicable Date.

**Other significant terms:**

- (1) The Company shall make payments to Weihai Baolong in cash monthly in arrears;
- (2) In the event that defects are found in the oil well pipe and casing billets supplied by Weihai Baolong, Weihai Baolong has agreed to exchange new oil well pipe and casing billets to the Company free of charge or indemnify the losses incurred by the Company in respect of the defects; and
- (3) Weihai Baolong has agreed to be responsible for distributing oil well pipe and casing billets to the factory of the Company, the costs of which would be borne by the Company.

### *The Oil Well Pipe and Casing Billets Annual Cap Amounts*

The Directors expect that the maximum aggregate annual value of sales of oil well pipe and casing billets by Weihai Baolong to the Company under the Oil Well Pipe and Casing Billets Supply Agreement is estimated not to exceed RMB38,000,000 (equivalent to approximately HK\$36,538,000) for the two months ending 31 December 2005, RMB750,000,000 (equivalent to approximately HK\$721,153,000) and RMB930,000,000 (equivalent to approximately HK\$894,231,000) (each, an “Oil Well Pipe and Casing Billets Annual Cap”) respectively for each of the two years ending 31 December 2007, which represents the target purchases agreed between the Company and Weihai Baolong.

## LETTER FROM THE BOARD

Set out below is the calculation of and the basis for the Oil Well Pipe and Casing Billets Annual Cap for the 2 months ending 31 December 2005 and 2 years ending 31 December 2007:

	<b>Projected production capacity of special seamless oil well pipes and casing (ton)</b>	<b>Production efficiency rate on the consumption of oil well pipe and casing billets to manufacture the special seamless oil well pipes and casing during the course of production (note 3)</b>	<b>Projected oil well pipe and casing billets to be consumed by the Company (ton)</b>	<b>Projected oil well pipe and casing billets to be purchased from Weihai Baolong (ton)</b>	<b>Oil Well Pipe and Casing Billets Annual Cap (RMB)</b>
For the two					
months ending	10,000	Approximately	11,500	10,000	38,000,000
31 December 2005	<i>(note 1)</i>	86.9%		<i>(note 4)</i>	<i>(note 5)</i>
For the year ending	210,000	Approximately	242,000	200,000	750,000,000
31 December 2006	<i>(notes 1 and 2)</i>	86.9%		<i>(note 4)</i>	<i>(note 5)</i>
For the year ending	310,000	Approximately	356,000	250,000	930,000,000
31 December 2007	<i>(notes 1 and 2)</i>	86.9%		<i>(note 4)</i>	<i>(note 5)</i>

*Notes:*

- (1) The annual production capacity of special seamless oil well pipes of the Company is expected to be approximately 60,000 tons in 2005 and the annual production capacity of special seamless oil well pipes of the Company is expected to be constant for the two years ending 31 December 2007 because the existing production facilities of the special seamless oil well pipes have reached their optimum production capacity.
- (2) The construction of the new 250,000-ton casing production facilities of the Company is expected to be completed at the end of 2005. It is anticipated that the annual production capacity of casing will be approximately 150,000 tons for the year 2006 and approximately 250,000 tons for the year 2007. The Directors expect that there will be an increase in the production capacity for the year 2007 after the new production facilities have gone through a certain testing period in 2006.
- (3) Oil well pipe and casing billets are the main raw materials for the production of special seamless oil well pipes and casing.
- (4) The Company expects to purchase the oil well pipe and casing billets from both independent third parties and Weihai Baolong in order to avoid the risk of relying on a single supplier.
- (5) A buffer of not more than 5% in excess of the Company's expected total value of the purchase from Weihai Baolong has been taken into account for reaching the Oil Well Pipe and Casing Billets Annual Cap.

### *Reason for the transaction*

The Group is engaged in the design, manufacture and sale of petroleum extraction machinery and related accessories. Oil well pipe and casing billets are used in the production of special seamless oil well pipes and casing.

As the annual production capacity of special seamless oil well casing produced by the Company has increased and is anticipated to continue to increase in future as set out in sub-paragraph (3) under the paragraph headed “The Oil Well Pipe and Casing Billets Annual Cap Amounts” above, the demand for oil well pipe and casing billets will increase accordingly. The Directors expect to secure long term and steady relationships with Weihai Baolong since the long-term suppliers enable a stable supply of raw materials to the Company which in turn guarantee a smooth production of the Company’s products.

The Board (including the independent non-executive Directors) also believe the terms and conditions of the Oil Well Pipe and Casing Billets Supply Agreement have been negotiated on an arm’s length basis and on normal commercial terms which are no less favourable than terms available from independent third parties since (a) Weihai Baolong has agreed to ensure timely supply of oil well pipe and casing billets according to the demands of the Company; (b) in the event that defects are found in the oil well pipe and casing billets supplied by Weihai Baolong, Weihai Baolong has agreed to exchange new oil well pipe and casing billets to the Company for free of charge or indemnify the losses incurred by the Company in respect of the defects; (c) the performance of oil well pipe and casing billets supplied by Weihai Baolong is suitable for the production of special seamless oil well pipes and casing of the Company and Weihai Baolong has agreed to set up a research and development centre for oil well pipe and casing billets to enhance the quality of oil well pipe and casing billets to be supplied to the Company; and (d) the supply price will be lower than the prevailing market price. The Board considers that the above help the Company to save its production costs, including but not limited to, the costs of raw materials and research and development costs. The Company can source the oil well pipe and casing billets from independent third parties.

In this connection, the Board (including the independent non-executive Directors) considers that the Oil Well Pipe and Casing Billets Supply Agreement is made in the ordinary and usual course of business of the Company and the terms of the Oil Well Pipe and Casing Billets Supply Agreement would be beneficial to the operation of the Company in terms of supply of raw materials and are in the interest of the Company and its Shareholders, taken as a whole.

### *Compliance requirements*

According to the GEM Listing Rules, the transaction mentioned above will constitute a continuing connected transaction of the Company and will be subject to the requirements of reporting, announcement and independent shareholders’ approval as required by Rules 20.45, 20.46, 20.47 and 20.48 of the GEM Listing Rules. As such, Mr. Zhang En Rong, Mr. Lin Fu Long, Mr. Zhang Yun San, Mr. Xie Xin Cang, Mr. Liu Yun Long and their respective associates (as the case may be) will abstain from voting in respect of the resolution approving this transaction at the EGM.

**(ii) The Metallurgy Accessories Supply Agreement**

*Date of the Metallurgy Accessories Supply Agreement*

22 September 2005

*Parties to the Metallurgy Accessories Supply Agreement*

Purchaser: The Company is principally engaged in the design, manufacture and sale of petroleum extraction machinery and related accessories

Seller: Molong Equipment, a non wholly-owned subsidiary of Maolong Machinery, is principally engaged in the production and sale of electrical equipment set and casting products

*Metallurgy accessories to be purchased*

Pursuant to the Metallurgy Accessories Supply Agreement, Molong Equipment has agreed to sell and the Company has agreed to purchase metallurgy accessories at the following terms:

Parties: Molong Equipment as seller

The Company as purchaser

Subject: Pursuant to the Metallurgy Accessories Supply Agreement, Molong Equipment has agreed to supply to the Company metallurgy accessories.

Term: The Metallurgy Accessories Supply Agreement is effective from the date of the EGM to 31 December 2007 (both dates inclusive), subject to the approval of the Independent Shareholders at the EGM.

Price: Pursuant to the Metallurgy Accessories Supply Agreement, it has been agreed that the price at which metallurgy accessories (which include plug, guide, piecing roll, rolling roll, disk, bar, SMR roll and straightening roll) are supplied to the Company by Molong Equipment will be as follows:

- (1) if the metallurgy accessories are subject to any fixed rates prescribed by the relevant authorities of the PRC (“**Prescribed Rates**”), the unit price of the relevant metallurgy accessories will adopt the Prescribed Rates. If the Prescribed Rates increase after the Company places its orders with Molong Equipment, the Prescribed Rates at the time of the placing of the order will be adopted. If the Prescribed Rates decrease after the Company places its orders but before delivery of metallurgy accessories by Molong Equipment, the Prescribed Rates at the time of delivery will be adopted;

## LETTER FROM THE BOARD

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- (2) if the metallurgy accessories are not subject to any Prescribed Rates, the price will be negotiated and agreed by both parties with reference to the Market Price (as defined below); and
- (3) the market price (“**Market Price**”) is the prevailing market price for the same type of metallurgy accessories provided by independent third parties in their ordinary course of business over the same period.

Under normal circumstances, the price of metallurgy accessories could be adjusted once annually by reference to the actual price of the relevant metallurgy accessories of the previous year plus an amount calculated based on the price index published by Weifang City Statistics Bureau. Where the price of the relevant metallurgy accessories suffers significant fluctuations (increase/decrease of more than 10%), the price could be re-negotiated between the parties.

Currently, there is no prevailing Prescribed Rates and the Market Price is approximately RMB11,600/ton. The Company has been purchasing metallurgy accessories from independent third parties, but Molong Equipment has agreed to provide a discount of RMB500/ton for the supply of metallurgy accessories. Hence the supply price of metallurgy accessories charged by Molong Equipment to the Company is RMB11,100/ton (“**Metallurgy Accessories Supply Price**”).

Historical figures:        There were no sales of metallurgy accessories by Molong Equipment to the Company up to the Latest Practicable Date.

Other significant terms:

- (1) The Company shall make payments to Molong Equipment in cash monthly in arrears; and
- (2) Molong Equipment has agreed to be responsible for distributing metallurgy accessories to the Company, the costs of which would be borne by Molong Equipment; the Company has agreed to be responsible for the expenses for inspecting the metallurgy accessories delivered.

### *The Metallurgy Accessories Annual Cap Amounts*

There will be no sales of metallurgy accessories by Molong Equipment to the Company for the year ending 31 December 2005.

The Directors expect that the maximum aggregate annual value of sales of metallurgy accessories by Molong Equipment to the Company under the Metallurgy Accessories Supply Agreement is estimated not to exceed RMB22,000,000 (equivalent to approximately HK\$21,154,000) and RMB27,000,000 (equivalent to approximately HK\$25,962,000) (each a “Metallurgy Accessories Annual Cap”) respectively for each of the two years ending 31 December 2007 which represents the target purchases agreed between the Company and Molong Equipment.

# LETTER FROM THE BOARD

Set out below is the calculation of and basis for the Metallurgy Accessories Annual Cap for the two years ending 31 December 2007:

	Projected volume of purchase of metallurgy accessories for the special seamless oil well pipes (ton) <i>(note 1)</i>	Market price of metallurgy accessories for the special seamless oil well pipes (RMB)	Total purchase amount of metallurgy accessories for the special seamless oil well pipes (RMB)	Projected volume of purchase of metallurgy accessories for the special seamless casing (ton) <i>(note 1)</i>	Market price of metallurgy accessories for the special seamless casing (RMB)	Total purchase amount of metallurgy accessories for special seamless casing (RMB)	Metallurgy Accessories Annual Cap (RMB)
For the year ending 31 December 2006	218 <i>(note 2)</i>	18,798	3,988,964 <i>(note 3)</i>	1,675 <i>(note 4)</i>	10,897	17,414,975 <i>(note 3)</i>	22,000,000 <i>(note 5)</i>
For the year ending 31 December 2007	218 <i>(note 2)</i>	18,798	3,988,964 <i>(note 3)</i>	2,094 <i>(note 4)</i>	10,897	21,771,318 <i>(note 3)</i>	27,000,000 <i>(notes 5 and 6)</i>

*Notes:*

- (1) Metallurgy accessories are the accessories required for the two production of special seamless oil well pipes and casing.
- (2) The annual production capacity of special seamless oil well pipes of the Company is expected to be approximately 60,000 tons in 2005 and the annual production capacity of the special seamless oil well pipes is expected to be constant for the two years ending 31 December 2007 because the existing production facilities of the special seamless oil well pipes have reached their optimum production capacity.
- (3) The total purchase amount has deducted an agreed discount of RMB500 per ton.
- (4) The construction of new 250,000-ton casing production facilities of the Company is expected to be completed at the end of 2005 and it is anticipated that the annual production capacity of casing of the Company will be approximately 150,000 tons for the year 2006 and approximately 250,000 tons for the year 2007. The Directors expect that there will be an increase in the production capacity for the year 2007 after the new production facilities have gone through a certain testing period in 2006.
- (5) A buffer of not more than 5% in excess of the Company's expected total value of the purchase from Molong Equipment has been taken into account for reaching the Metallurgy Accessories Annual Cap.
- (6) The Metallurgy Accessories Supply Price of RMB11,100 is calculated by reference to (1) the Metallurgy Accessory Annual Cap for the year ending 31 December 2007, divided by the total purchase volume of metallurgy accessories for special seamless oil well pipes and casing for the same year; and (2) the agreed discount of RMB500 per ton.

***Reason for the transaction***

Metallurgy accessories are important accessories used for the proper operation of the production lines of special seamless oil well pipes and casing.

## LETTER FROM THE BOARD

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As the annual production capacity of special seamless oil well casing produced by the Company has increased and is anticipated to continue to increase in future as set out in sub-paragraph (3) under the paragraph headed “The Metallurgy Accessories Annual Cap Amounts” above, the demand for metallurgy accessories will increase accordingly. The Directors consider that long term and steady relationships with suppliers are of importance to the Company as they enable a stable supply of accessories to the Company which in turn guarantee the proper operation of the production lines of special seamless oil well pipes and casing.

The Board (including the independent non-executive Directors) also believe the terms and conditions of the Metallurgy Accessories Supply Agreement have been negotiated on an arm’s length basis and on normal commercial terms which are no less favourable than terms available from independent third parties since (a) Molong Equipment has agreed to be responsible for the expenses for distributing metallurgy accessories to the Company; (b) the performance of metallurgy accessories supplied by Molong Equipment is suitable for the production lines of special seamless oil well pipes and casing of the Company; and (c) the Metallurgy Accessories Supply Price will not be higher than the Market Price and the price of the same products purchased by the Company from independent third parties in their normal course of business over the same period. The Board considers that the above help the Company to save its costs, including but not limited to, the production costs. The Company can source the metallurgy accessories from independent third parties.

In this connection, the Board (including the independent non-executive Directors) considers that the Metallurgy Accessories Supply Agreement is made in the ordinary and usual course of business of the Company and the terms of the Metallurgy Accessories Supply Agreement would be beneficial to the operation of the Company in terms of supply of raw materials and are in the interest of the Company and its Shareholders, taken as a whole.

### *Compliance requirements*

According to the GEM Listing Rules, the transaction mentioned above will constitute a continuing connected transaction of the Company and will be subject to the requirements of reporting, announcement and independent shareholders’ approval as required by Rules 20.45, 20.46, 20.47 and 20.48 of the GEM Listing Rules. As such, Mr. Zhang En Rong, Mr. Lin Fu Long, Mr. Zhang Yun San, Mr. Xie Xin Cang, Mr. Liu Yun Long and their respective associates (as the case may be) will abstain from voting in respect of the resolution for approving this transaction at the EGM.

### **(iii) The Scrap and Used Metals Supply Agreement**

#### *Date of the Scrap and Used Metals Supply Agreement*

22 September 2005



## LETTER FROM THE BOARD

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### *Parties to the Scrap and Used Metals Supply Agreement*

Purchaser: Molong Equipment, a non wholly-owned subsidiary of Maolong Machinery, is principally engaged in the production and sale of electrical equipment set and casting products

Seller: The Company is principally engaged in the design, manufacture and sale of petroleum extraction machinery and related accessories

### *Scrap and used metals to be sold*

Pursuant to the Scrap and Used Metals Supply Agreement, the Company has agreed to sell and Molong Equipment has agreed to purchase scrap and used metals at the following terms:

Parties: The Company as seller

Molong Equipment as purchaser

Subject: Pursuant to the Scrap and Used Metals Supply Agreement, the Company has agreed to supply to Molong Equipment scrap and used metals.

Term: The Scrap and Used Metals Supply Agreement is effective from the date of the EGM to 31 December 2007 (both dates inclusive), subject to the approval of the Independent Shareholders at the EGM

Price: Pursuant to the Scrap and Used Metals Supply Agreement, it has been agreed that the price at which scrap and used metals are supplied to Molong Equipment by the Company will be as follows:

- (1) if the scrap and used metals are subject to any fixed rates prescribed by the relevant authorities of the PRC (“**Prescribed Rates**”), the unit price of the relevant scrap and used metals will adopt the Prescribed Rates. If the Prescribed Rates increase after Molong Equipment places its orders with the Company, the Prescribed Rates at the time of the placing of the order will be adopted. If the Prescribed Rates decrease after Molong Equipment places its orders but before delivery of scrap and used metals by the Company, the Prescribed Rates at the time of delivery will be adopted;
- (2) if the scrap and used metals are not subject to any Prescribed Rates, the price will be negotiated and agreed by both parties with reference to the Market Price (as defined below); and
- (3) the market price (“**Market Price**”) is the prevailing market price charged by the Company to independent third parties for scrap and used metals over the same period.

## LETTER FROM THE BOARD

Under normal circumstances, the price of scrap and used metals could be adjusted once annually by reference to the actual price of the scrap and used metals of the previous year plus an amount calculated based on the price index published by Weifang City Statistics Bureau. Where the price of the relevant scrap and used metals suffers significant fluctuations (increase/decrease of more than 10%), the price could be re-negotiated between the parties.

Currently, there is no prevailing Prescribed Rate and the Market Price is approximately RMB1,930/ton and the supply price of scrap and used metals charged by the Company to Molong Equipment has been agreed to be RMB1,930/ton (“**Scrap and Used Metals Supply Price**”).

The Company has been providing scrap and used metals to both independent third parties and Molong Equipment.

Historical  
figures:

For each of the two years ending 31 December 2004, the total sales of scrap and used metals by the Company to Molong Equipment was approximately RMB541,000 (equivalent to approximately HK\$520,000) and approximately RMB622,000 (equivalent to approximately HK\$598,000). For the seven months ending 31 July 2005, the total sales of scrap and used metals by the Company to Molong Equipment was approximately RMB656,000 (equivalent to approximately HK\$631,000).

Other  
significant  
terms:

- (1) Molong Equipment shall make payments to the Company in cash monthly in arrears; and
- (2) The Company has agreed to be responsible for the expenses for distributing scrap and used metals to Molong Equipment, and Molong Equipment has agreed to be responsible for the expenses for inspecting the scrap and used metals delivered.

### *The Scrap and Used Metals Annual Cap Amounts*

The Directors expect that the maximum aggregate annual value of sales of scrap and used metals to Molong Equipment by the Company under the Scrap and Used Metals Supply Agreement is estimated not to exceed RMB5,000,000 (equivalent to approximately HK\$4,808,000) for the two months ending 31 December 2005, RMB19,200,000 (equivalent to approximately HK\$18,462,000) and RMB28,200,000 (equivalent to approximately HK\$27,115,000) (each, a “**Scrap and Used Metals Annual Cap**”) respectively for each of the two years ending 31 December 2007 which represents the target sales agreed between the Company and Molong Equipment.

## LETTER FROM THE BOARD

The Directors expect that there will be a substantial increase in the Scrap and Used Metals Annual Cap from 2006 to 2007 on the basis that (1) the scrap and used metals are side products generated during the production process of special oil well pipes and casing, whereas scrap and used metals are the main raw materials for producing Molong Equipment's casting products; (2) the casing production capacity of the Company is expected to be increased from approximately 150,000 tons for the year 2006 to approximately 250,000 tons for the year 2007, as explained below; and (3) the production capacity of Molong Equipment has increased and is anticipated to continue to increase in future which has resulted and will result in an increase in demand of scrap and used metals.

Set out below is the calculation of and the basis for the Scrap and Used Metals Annual Cap for the two months ending 31 December 2005 and 2 years ending 31 December 2007:

	<b>Projected production capacity of special seamless oil well pipes and casing (ton)</b>	<b>The yield of the scrap and used metals generated during the course of production of oil well pipe and casing billets (note 3)</b>	<b>Projected scrap and used metals to be supplied by the Company (ton)</b>	<b>Scrap and Used Metals Annual Cap (RMB)</b>
For the two months ending 31 December 2005	10,000	4.52%	2,500 <i>(note 4)</i>	5,000,000 <i>(note 5)</i>
For the year ending 31 December 2006 <i>(notes 1 and 2)</i>	210,000	4.52%	9,800	19,200,000 <i>(note 5)</i>
For the year ending 31 December 2007 <i>(notes 1 and 2)</i>	310,000	4.52%	14,600	28,200,000 <i>(note 5)</i>

*Notes:*

- (1) The annual production capacity of special seamless oil well pipes of the Company is expected to be approximately 60,000 tons in 2005 and the annual production capacity of special seamless oil well pipes is expected to be constant for the two years ending 31 December 2007 because the existing production facilities of the special seamless oil well pipes have reached their optimum production capacity.
- (2) The construction of new 250,000-ton casing production facilities of the Company is expected to be completed at the end of 2005. It is anticipated that the annual production capacity of casing will be approximately 150,000 tons for the year 2006 and approximately 250,000 tons for the year 2007. The Directors expect that there will be an increase in the production capacity for the year 2007 after the new production facilities have gone through a certain testing period in 2006.
- (3) Scrap and used metals are side products generated during the production process of special seamless oil well pipes and casing, whereas scrap and used metals are the main raw materials for producing Molong Equipment's casting products.

## LETTER FROM THE BOARD

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- (4) Apart from the scrap and used metals of approximately 450 tons generated during the course of production, certain scrap and used metals of approximately 2,050 tons, which are at present stored in the warehouse of the Company, would be supplied to Molong Equipment after the approval is sought from the Independent Shareholders at the EGM.
- (5) A buffer of not more than 5% in excess of the Company's expected total value of the supply has been taken into account for reaching the Scrap and Used Metals Annual Cap.

### *Reason for the transaction*

Molong Equipment is principally engaged in the production and sale of electrical equipment set and casting products, and scrap and used metals are the main raw materials for producing its casting products. The Company is engaged in the design, manufacture and sale of petroleum extraction machinery and related accessories, and scrap and used metals are the side products generated during the production process of special seamless oil well pipes and casing.

As the production capacity of Molong Equipment has increased and is anticipated to continue to increase in future which has resulted and will result in an increase in demand of scrap and used metals and, at the same time, it is expected that the amount of scrap and used metals generated by the Company will increase as the production capacity of casing of the Company has increased and is anticipated to continue to increase in future as set out in sub-paragraph (3) under the paragraph headed "The Scrap and Used Metals Annual Cap Amounts" above. The Directors consider that the long term relationship with Molong Equipment in the supply of scrap and used metals is of importance to the Company as this can enable a stable demand of scrap and used metals from Molong Equipment which in turn generates a smooth income from sales of the Company's side products.

The Board (including the independent non-executive Directors) also believe the terms and conditions of the Scrap and Used Metals Supply Agreement have been negotiated on an arm's length basis and on normal commercial terms which are no less favourable than terms offered to independent third parties since the Scrap and Used Metals Supply Price will not be lower than that of the same products sold by the Company to independent third parties in its normal course of business over the same period.

In this connection, the Board (including the independent non-executive Directors) considers that the Scrap and Used Metals Supply Agreement is made in the ordinary and usual course of business of the Company and the terms of the Scrap and Used Metal Supply Agreement would be beneficial to the operation of the Company and are in the interest of the Company and its Shareholders, taken as a whole.

### *Compliance requirements*

According to the GEM Listing Rules, the transaction mentioned above will constitute a continuing connected transaction of the Company and will be subject to the requirements of announcement and independent shareholders' requirements as required by Rules 20.45, 20.46, 20.47 and 20.48 of the GEM Listing Rules. As such, Mr. Zhang En Rong, Mr. Lin Fu Long, Mr. Zhang Yun San, Mr. Xie Xin Cang, Mr. Liu Yun Long, and their respective associates (as the case may be) will abstain from voting in respect of the resolution approving this transaction at the EGM.

### **(iv) Background**

#### *Relationship with Maolong Machinery, Weihai Baolong and Molong Equipment*

Maolong Machinery is a limited liability company established in the PRC on 1 August 2000. It is principally engaged in the production and sale of oil equipment and accessories, high pressure isolation switches, high pressure electric appliances, and related equipment sets; processing and sale of alloy accessories since establishment. Maolong Machinery is owned as to 53.15% by Mr. Zhang Yun Qi and as to 46.85% by 12 other shareholders. Zhang Yun Qi is the brother of Zhang Yun San and the son of Zhang En Rong. He is also the director of Maolong Machinery. Zhang Yun San and Zhang En Rong are Directors and management shareholders holding in aggregate approximately 47.8% of the equity interest in the Company. Pursuant to Rule 20.11(1) of the GEM Listing Rules, Zhang En Rong and Zhang Yun San are connected persons of the Company. As Zhang Yun Qi is the son of Zhang En Rong and the brother of Zhang Yun San, he is deemed to be an associate of the Directors and accordingly, is also a connected person of the Company. As Zhang Yun Qi is interested in approximately 53.15% of the equity interest in Maolong Machinery, Maolong Machinery is deemed to be a connected person of the Company.

Weihai Baolong, a non wholly-owned subsidiary of Maolong Machinery, is owned as to 95% by Maolong Machinery and 5% by Molong Equipment. Given that Maolong Machinery is deemed to be a connected person of the Company and Weihai Baolong is a subsidiary of Maolong Machinery, Weihai Baolong is also deemed to be a connected person of the Company.

Molong Equipment, also a non wholly-owned subsidiary of Maolong Machinery, is owned as to 55% by Maolong Machinery and 45% by an independent third party. Given that Maolong Machinery is deemed to be a connected person of the Company and Molong Equipment is a subsidiary of Maolong Machinery, Molong Equipment is also deemed to be a connected person of the Company.

**3. CONNECTED TRANSACTION**

**The Machinery Accessories Supply Agreement**

*Date of the Machinery Accessories Supply Agreement*

22 September 2005

*Parties to the Machinery Accessories Supply Agreement*

Purchaser: The Company is principally engaged in the design, manufacture and sale of petroleum extraction machinery and related accessories

Seller: Molong Equipment, a non wholly-owned subsidiary of Maolong Machinery, is principally engaged in the production and sale of electrical equipment set and casting products

*Machinery accessories to be purchased*

Pursuant to the Machinery Accessories Supply Agreement, Molong Equipment has agreed to sell and the Company has agreed to purchase machinery accessories at the following terms:

Parties: Molong Equipment as seller

The Company as purchaser

Subject: Pursuant to the Machinery Accessories Supply Agreement, Molong Equipment has agreed to sell to the Company machinery accessories (such as high pressure cupboards, low pressure electric appliances, electric appliances and related equipment sets).

Term: The Machinery Accessories Supply Agreement is effective from the approval of the Independent Shareholders at the EGM.

Price: Pursuant to the Machinery Accessories Supply Agreement, it has been agreed that the aggregate price at which the machinery accessories are supplied to the Company by Molong Equipment is RMB33,000,000 (equivalent to approximately HK\$31,731,000) (“**Supply Price**”) which is determined with reference to the prevailing market price and is not higher than that of the same products sold by Molong Equipment to independent third parties in its normal course of business over the same period. A buffer of not more than 5% in excess of the Company’s expected total value of the purchase from Molong Equipment has been taken into account for reaching the Supply Price.

## LETTER FROM THE BOARD

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- Other significant terms:
- (1) Molong Equipment shall deliver the machinery accessories to the Company on the dates specified in the Machinery Accessories Supply Agreement;
  - (2) the quality and technological standard of the machinery accessories supplied by Molong Equipment to the Company shall comply with the relevant national standard in the PRC; and
  - (3) Molong Equipment has agreed to be responsible for the expenses for distributing the machinery accessories to the Company; and the Company has agreed to be responsible for the expenses for inspecting the machinery accessories delivered.

### *Consideration of the purchase of machinery accessories from Molong Equipment*

The total consideration payable by the Company to Molong Equipment for the acquisition of machinery accessories pursuant to the Machinery Accessories Supply Agreement shall be approximately RMB33,000,000 (equivalent to approximately HK\$31,731,000) and will be settled in cash. The consideration is determined with reference to the prevailing market price and is not higher than that of the same products sold by Molong Equipment to independent third parties in its normal course of business over the same period.

### *Reason for the transaction*

The Company selected a supplier for the supply of the machinery accessories through a bidding process. The Directors advised that the bidding price from Molong Equipment is lower than those of the other suppliers. Therefore, the Company has decided to enter into the Machinery Accessories Supply Agreement with Molong Equipment for the supply of the machinery accessories.

### *Compliance requirements*

As Molong Equipment is deemed to be a connected person of the Company, the transaction constitutes a connected transaction of the Company under Rule 20.13(1) of the GEM Listing Rules and will be subject to the requirements of reporting, announcement and independent shareholders' approval. As such, Mr. Zhang En Rong, Mr. Lin Fu Long, Mr. Zhang Yun San, Mr. Xie Xin Cang, Mr. Liu Yun Long and their respective associates (as the case may be) will abstain from voting in respect of the resolution approving this transaction.

## **4. EGM**

Set out in pages 45 to 47 of this circular is the notice to convene and hold the EGM at No.99 Beihai Road, Shouguang City, Shangdong Province, The People's Republic of China at 3:00 p.m. on 28 November 2005. It is proposed that ordinary resolutions for the approval of the Transactions and the Annual Caps be put to the Shareholders for their consideration at the EGM and voting by way of poll at the EGM.

## LETTER FROM THE BOARD

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For the purposes of the EGM, the register of members of the Company will be closed from 28 October 2005 to 28 November 2005 (both days inclusive), during which no transfer of shares will be registered. Accordingly, holders of H shares of the Company and holders of domestic shares of the Company whose names appear on the register of members of the Company at the close of business on 27 October 2005 shall have the right to attend the EGM.

Each Shareholder who has the right to attend and vote at the EGM, is entitled to appoint one or more proxies, whether they are Shareholders or not, to attend and vote on his behalf at the EGM.

A proxy form for use in connection with the EGM is enclosed. Whether or not you are able to attend the meeting, please complete and return the enclosed proxy form in accordance with the instructions printed thereon as soon as practicable and in any event not less than 24 hours before the time appointed for holding of the EGM or any adjournment thereof. Completion and return of the proxy form will not preclude you from attending and voting in person at the meeting or any adjourned meeting (as the case may be) should you so wish.

Mr. Zhang En Rong, Mr. Lin Fu Long, Mr. Zhang Yun San, Mr. Xie Xin Cang, Mr. Liu Yun Long and their respective associates will abstain from voting at the EGM.

### 5. POLL PROCEDURE

Set out below is the procedure by which Shareholders and the chairman of any Shareholders' meeting may demand a poll pursuant to article 77 of the articles of association of the Company, subject to the requirements under the GEM Listing Rules:

“At any general meeting of shareholders, a resolution shall be decided on a show of hands unless a poll is demanded before or after any vote by show of hands by:

- (1) the chairman of the meeting;
- (2) at least two shareholders, who possess the right to vote, present in person or by proxy; or
- (3) any shareholder or shareholders present in person or by proxy and representing in the aggregate not less than one-tenth of the total voting rights of all shareholders having the right to attend and vote at the meeting.

Unless a poll be so demanded, a declaration by the chairman of the meeting that a resolution has on a show of hands been carried and an entry to that effect in the minutes of the meeting shall be conclusive evidence of the fact, without proof of the number or proportion of the votes recorded in favour of or against such resolution, that the resolution has been carried.

A demand for a poll may be withdrawn by the person who made the demand.”



**6. RECOMMENDATION**

The Board, including the Independent Board Committee, is of the opinion that the terms of the Transactions and the Annual Caps are fair and reasonable so far as the Company is concerned and are in the interests of the Company and the Shareholders as a whole. The Board is also of the view that the Transactions have been negotiated on an arm's length's basis and entered into in the ordinary course of business. Accordingly, the Board (including the Independent Board Committee) recommends that the Independent Shareholders vote in favour of the ordinary resolutions set out in the notice of the EGM for the approval of the Transactions and the Annual Caps.

**7. INDEPENDENT BOARD COMMITTEE**

The Independent Board Committee, comprising Mr. Qin Xue Chang, Mr. Yan Yi Zhuang and Mr. Loke Yu, has been formed to advise the Independent Shareholders in respect of the Transactions and the Annual Caps. China Everbright Capital Limited has been appointed as the independent financial adviser for the purpose of advising the Independent Board Committee and the Independent Shareholders in respect of the Transactions and the Annual Caps.

**8. ADDITIONAL INFORMATION**

Your attention is drawn to the additional information set out in the Appendix to this circular.

Yours faithfully,  
**Shandong Molong Petroleum Machinery  
Company Limited**  
**Zhang En Rong**  
*Chairman*



**山東墨龍石油機械股份有限公司**

Shandong Molong Petroleum Machinery Company Limited

*(A Sino-foreign joint stock limited company incorporated in the People's Republic of China with limited liability)*

**(Stock Code: 8261)**

7 October 2005

*To the Independent Shareholders*

Dear Sir or Madam,

## **CONTINUING CONNECTED TRANSACTIONS AND CONNECTED TRANSACTION**

We have been appointed as the Independent Board Committee to advise the Independent Shareholders on whether the terms of the Transactions and the Annual Caps are fair and reasonable. Details of the Transactions are set out in the letter from the Board contained in the circular to the Shareholders dated 7 October 2005 (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, among other matters, the factors and reasons considered by, and the opinions of China Everbright Capital Limited as stated in its letter of advice set out on pages 24 to 38 of the Circular, we are of the opinion that the terms of the Transactions and the Annual Caps are fair and reasonable and the Transactions and the Annual Caps are in the interests of the Company and the Shareholders as a whole. We therefore recommend the Independent Shareholders to vote in favour of the ordinary resolutions to be proposed at the EGM to approve the Transactions and the Annual Caps.

Yours faithfully,

**Mr. Qin Xue Chang**  
*Independent*  
*non-executive Director*

**Mr. Yan Yi Zhuang**  
*Independent*  
*non-executive Director*

**Mr. Loke Yu alias**  
**Loke Hoi Lam**  
*Independent*  
*non-executive Director*

# LETTER FROM CHINA EVERBRIGHT CAPITAL LIMITED

The following is the text of a letter of advice from China Everbright Capital Limited to the Independent Board Committee and the Independent Shareholders in respect of the Continuing Connected Transactions, the Annual Caps and the Connected Transaction, which has been prepared for the purpose of inclusion in this circular:



China Everbright Capital Limited  
40/F., Far East Finance Centre  
16 Harcourt Road  
Hong Kong

7 October 2005

To: the Independent Board Committee and the Independent Shareholders

Dear Sirs,

## **CONTINUING CONNECTED TRANSACTIONS AND CONNECTED TRANSACTION**

We refer to our appointment as the independent financial adviser to advise the Independent Board Committee and the Independent Shareholders in respect of (i) the Continuing Connected Transactions and the Annual Caps and (ii) the Connected Transaction, particulars of which are set out in a circular to the Shareholders dated 7 October 2005 (the “Circular”) and in which this letter is reproduced. Unless the context requires otherwise, terms used in this letter shall have the same meanings as given to them in the Circular.

As Maolong Machinery is deemed to be a connected person of the Company and Weihai Baolong and Molong Equipment are non wholly-owned subsidiaries of Maolong Machinery, Weihai Baolong and Molong Equipment are also deemed to be connected persons of the Company. The Continuing Connected Transactions comprise:

- (i) purchase of oil well pipe and casing billets by the Company from Weihai Baolong (the “Purchase of Oil Well Pipe and Casing Billets”);
- (ii) purchase of metallurgy accessories by the Company from Molong Equipment (the “Purchase of Metallurgy Accessories”); and
- (iii) sales of scrap and used metals by the Company to Molong Equipment (the “Sales of Scrap and Used Metals”).

Each of the above transactions constitutes a continuing connected transaction for the Company under Rule 20.14 of the GEM Listing Rules. As the annual consideration in respect of the Purchase of Oil Well Pipe and Casing Billets for each of the three years ending 31 December 2007, the annual

consideration in respect of the Purchase of Metallurgy Accessories for each of the two years ending 31 December 2007 and the annual consideration in respect of the Sales of Scrap and Used Metals for each of the two years ending 31 December 2007 exceed HK\$10 million, each of the above transactions will constitute a non-exempt continuing connected transaction for the Company and therefore will be subject to the reporting, announcement and independent shareholders' approval requirements under Chapter 20 of the GEM Listing Rules.

Pursuant to the Machinery Accessories Supply Agreement, Molong Equipment has agreed to sell and the Company has agreed to purchase machinery accessories at a total consideration of approximately RMB33,000,000 (equivalent to approximately HK\$31,731,000). As Molong Equipment is deemed to be a connected person of the Company, the transaction constitutes a connected transaction of the Company under Rule 20.13(1) of the GEM Listing Rules and will be subject to the reporting, announcement and independent shareholders' approval requirements under Chapter 20 of the GEM Listing Rules.

Approvals will be sought from the Independent Shareholders at the EGM in relation to the resolutions approving the Continuing Connected Transactions and their respective Annual Caps and the Connected Transaction. As such, Mr. Zhang En Rong, Mr. Zhang Yun San, Mr. Lin Fu Long, Mr. Xie Xin Cang, Mr. Liu Yun Long and their respective associates (as the case may be) holding approximately 58.7% of the equity interests in the Company will abstain from voting in respect of the above resolutions. Mr. Zhang En Rong, Mr. Zhang Yun San, Mr. Lin Fu Long, Mr. Xie Xin Cang and Mr. Liu Yun Long will abstain from voting in respect of the above resolutions because each of them, being the shareholders of the Company, is interested or is deemed to be interested in the equity interests of Maolong Machinery.

In formulating our opinion, we have relied on the accuracy of the information and representations provided to us by the Company and contained in the Circular, and have assumed that all information and representations made or referred to in the Circular were true at the time they were made and continue to be true as at 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 enquiry. We consider that we have reviewed sufficient information to reach an informed view, to justify relying on the accuracy of the information contained in the Circular and to provide a reasonable basis for our opinion. We have no reason to suspect that any material facts have been omitted or withheld from the information contained or opinion expressed in the Circular nor to doubt the truth, accuracy and completeness of the information and representations provided to us by the Directors. We have not, however, carried out any independent verification of the information and representations provided by the Company, nor have we conducted an independent in-depth investigation into the business and affairs of the Group.

**CONTINUING CONNECTED TRANSACTIONS**

**Principal reasons and factors considered**

In arriving at our recommendation to the Independent Board Committee and the Independent Shareholders in respect of the Continuing Connected Transactions and the Annual Caps, we have considered the following principal reasons and factors:

**(i) Background and reasons for, and benefits of, the Continuing Connected Transactions**

The Group is engaged in the design, manufacture and sales of petroleum extraction machinery and related accessories. The Group's products include five main categories, namely, oil well pipes, oil well sucker rods, oil well pumps, oil well pumping machines, and other petroleum extraction machinery accessories.

Weihai Baolong, a non wholly-owned subsidiary of Maolong Machinery, is principally engaged in the sale and manufacture of special metallic materials for petroleum.

Molong Equipment, a non wholly-owned subsidiary of Maolong Machinery, is principally engaged in the production and sale of electrical equipment set and casting products.

The Company has started to engage in the manufacture of special seamless oil well pipes in June 2004 and will start to engage in the manufacture of special seamless oil well casing in year 2006. Special seamless oil well pipes and special seamless oil well casing are used in the manufacture of the inner shell and the outer shell of an oil well pipe respectively.

The annual volume of special seamless oil well pipes produced by the Company is expected to be approximately 60,000 tons in 2005 and the annual volume of special seamless oil well pipes produced by the Company is expected to be constant for the two years ending 31 December 2007 because the existing production facilities of the special seamless oil well pipes of the Company have reached their optimum production capacity.

The construction of the new 250,000-ton special seamless oil well casing production facilities of the Company is expected to be completed at the end of 2005. It is anticipated that the annual volume of special seamless oil well casing produced by the Company will be approximately 150,000 tons in 2006 and approximately 250,000 tons in 2007. The Directors expect that there will be an increase in the production capacity in 2007 after the new production facilities have gone through a certain testing period in 2006.

Oil well pipe and casing billets are the main raw materials for the production of special seamless oil well pipes and casing. In addition, during the course of production of special seamless oil well pipes and casing, metallurgy accessories are important accessories used for the proper operation of the production lines of special seamless oil well pipes and casing.

As the annual volume of special seamless oil well casing produced by the Company has increased and is anticipated to increase in the future, the demand for oil well pipe and casing billets and metallurgy accessories will increase accordingly.

Scrap and used metals are the main raw materials for producing the casting products of Molong Equipment. Scrap and used metals are the side products generated during the production process of special seamless oil well pipes and casing. As the production capacity of Molong Equipment has increased and is anticipated to continue to increase in the future which has resulted and will result in an increase in demand of scrap and used metals and, at the same time, it is expected that the amount of scrap and used metals generated by the Company will increase as the production capacity of special seamless oil well casing of the Company has increased and is anticipated to continue to increase in the future.

(a) *Purchase of Oil Well Pipe and Casing Billets*

On 22 September 2005, the Company and Weihai Baolong entered into the Oil Well Pipe and Casing Billets Supply Agreement, pursuant to which Weihai Baolong has agreed to supply to the Company oil well pipe and casing billets effective from the date of the EGM to 31 December 2007 (both dates inclusive), subject to the approval of the Independent Shareholders at the EGM.

Weihai Baolong has agreed (i) to ensure timely supply of oil well pipe and casing billets according to the demands of the Company; (ii) to exchange new oil well pipe and casing billets to the Company for free of charge or indemnify the losses incurred by the Company in respect of any defects in the event that defects are found in the oil well pipe and casing billets supplied by Weihai Baolong; (iii) to set up a research and development centre for oil well pipe and casing billets to enhance the quality of oil well pipe and casing billets to be supplied to the Company so that the performance of oil well pipe and casing billets supplied by Weihai Baolong is suitable for the production of special seamless oil well pipes and casing of the Company; and (iv) that the supply price will be lower than the prevailing market price. As such, other than the lower purchase cost, the quality and supply of oil well pipe and casing billets can be assured. Apart from purchase from Weihai Baolong, the Company can source oil well pipe and casing billets from independent third parties.

There were no sales of oil well pipe and casing billets by Weihai Baolong to the Company up to the Latest Practicable Date. The Directors consider that the assured quality of oil well pipe and casing billets as well as the long term and steady relationship with Weihai Baolong is of importance to the Company as it will enable a stable supply of quality raw materials to the Company which in turn guarantee a smooth production of the Company's products. In addition, the purchase from Weihai Baolong can reduce the Company's production costs, including but not limited to, the costs of raw materials and research and development costs.

As such, we concur with the Directors' view that the Purchase of Oil Well Pipe and Casing Billets would be beneficial to the operation of the Company in terms of supply of raw materials and is in the interests of the Company and its Shareholders as a whole.

(b) *Purchase of Metallurgy Accessories*

On 22 September 2005, the Company and Molong Equipment entered into the Metallurgy Accessories Supply Agreement, pursuant to which Molong Equipment has agreed to supply to the Company metallurgy accessories effective from the date of the EGM to 31 December 2007 (both dates inclusive), subject to the approval of the Independent Shareholders at the EGM.

Metallurgy accessories (which include plug, guide, piecing roll, rolling roll, disk, bar, SMR roll and straightening roll) are important accessories used for the proper operation of the production lines of special seamless oil well pipes and casing. Apart from purchase from Molong Equipment, the Company can source metallurgy accessories from independent third parties.

Molong Equipment has agreed (i) to ensure the performance of metallurgy accessories supplied to the Company is suitable for the production lines of special seamless oil well pipes and casing of the Company; (ii) to be responsible for the expenses for distributing metallurgy accessories to the Company that can reduce the distributing expenses of the Company as a whole; and (iii) that supply price will not be higher than the prevailing market price and the price of the same products purchased by the Company from independent third parties in their normal course of business over the same period.

There were no sales of metallurgy accessories by Molong Equipment to the Company up to the Latest Practicable Date. The Directors consider that the long term and steady relationship with Molong Equipment is of importance to the Company as it will enable a stable supply of metallurgy accessories to the Company which in turn guarantee the proper operation of the production lines of special seamless oil well pipes and casing. In addition, the Purchase of Metallurgy Accessories can enable the Company to save its costs, including but not limited to, the production costs.

In light of the above, we concur with the Directors' view that the Purchase of Metallurgy Accessories would be beneficial to the operation of the production lines of special seamless oil well pipes and casing of the Company and is in the interests of the Company and its Shareholders as a whole.

(c) *Supply of Scrap and Used Metals*

On 22 September 2005, the Company and Molong Equipment entered into the Scrap and Used Metals Supply Agreement, pursuant to which the Company has agreed to supply

to Molong Equipment scrap and used metals effective from the date of the EGM to 31 December 2007 (both dates inclusive), subject to the approval of the Independent Shareholders at the EGM:

Scrap and used metals are the main raw materials for producing the casting products of Molong Equipment. Scrap and used metals are the side products generated during the production process of special seamless oil well pipes and casing. The Directors consider that the long term relationship with Molong Equipment in the supply of scrap and used metals is of importance to the Company as this can enable a stable demand of scrap and used metals from Molong Equipment which in turn generates a smooth income from sales of the Company's side products. The Company has been providing scrap and used metals to both independent third parties and Molong Equipment. Approximately 99% of the scrap and used metals of the Company have been sold to Molong Equipment, the remaining 1% of scrap and used metals of the Company have been sold to independent third parties. The Directors expect that all scrap and used metals of the Company will be sold to Molong Equipment for the two months ending 31 December 2005 and the two years ending 31 December 2007.

Having considered the above reasons for, and benefits of, the Continuing Connected Transactions, we consider that the Continuing Connected Transactions are in the interests of the Company and its Shareholders as a whole.

## (ii) **Terms of the Continuing Connected Transactions**

### (a) *Purchase of Oil Well Pipe and Casing Billets*

#### (i) Price

Pursuant to the Oil Well Pipe and Casing Billets Supply Agreement, it has been agreed that the supply price of oil well pipe and casing billets charged by Weihai Baolong to the Company will be the prevailing market price less an agreed discount of not more than RMB100/ton ("Oil Well Pipe and Casing Billets Supply Price"). The current prevailing market price is approximately RMB3,800/ton.

Taking into account the above pricing basis such that the Oil Well Pipe and Casing Billets Supply Price is not less favourable than that offered by independent third parties, we consider that the Oil Well Pipe and Casing Billets Supply Price is fair and reasonable and is in the interests of the Company and the Independent Shareholders as a whole.

#### (ii) Payment terms

The Company shall make payments to Weihai Baolong in cash monthly in arrears.



(iii) Other significant terms

Weihai Baolong has agreed that in the event that defects are found in the oil well pipe and casing billets supplied by Weihai Baolong, Weihai Baolong shall exchange new oil well pipe and casing billets to the Company for free of charge or indemnify the losses incurred by the Company in respect of the defects. In addition, Weihao Baolong has also agreed to be responsible for distributing oil well pipe and casing billets to the factory of the Company, the costs of which would be borne by the Company.

Having reviewed the relevant documents in respect of the terms provided by Weihai Baolong and considered such cost saving benefits enjoyed by the Company as stated in the paragraph headed “Background and reasons for, and benefits of, the Continuing Connected Transactions” above, we concur with the Directors’ view that the Purchase of Oil Well Pipe and Casing Billets has been negotiated on an arm’s length basis and is on normal commercial terms, and that the terms of the Oil Well Pipe and Casing Billets Supply Agreement are fair and reasonable and are in the interests of the Company and the Independent Shareholders as a whole.

(b) *Purchase of Metallurgy Accessories*

(i) Price

Pursuant to the Metallurgy Accessories Supply Agreement, it has been agreed that the price at which metallurgy accessories are supplied to the Company by Molong Equipment will be as follows:

- (1) if the metallurgy accessories are subject to any fixed rates prescribed by the relevant authorities of the PRC (“Prescribed Rates”), the unit price of the relevant metallurgy accessories will adopt the Prescribed Rates. If the Prescribed Rates increase after the Company places its orders with Molong Equipment, the Prescribed Rates at the time of the placing of the order will be adopted. If the Prescribed Rates decrease after the Company places its orders but before delivery of metallurgy accessories by Molong Equipment, the Prescribed Rates at the time of delivery will be adopted;
- (2) if the metallurgy accessories are not subject to any Prescribed Rates, the price will be negotiated and agreed by both parties with reference to the Market Price (as defined below); and
- (3) the market price (“Market Price”) is the prevailing market price for the same type of metallurgy accessories provided by independent third parties in their ordinary course of business over the same period.

Under normal circumstances, the price of metallurgy accessories could be adjusted once annually by reference to the actual price of the relevant metallurgy accessories of the previous year plus an amount calculated based on the price index published by Weifang City Statistics Bureau. Where the price of the relevant metallurgy accessories suffers significant fluctuations (increase/decrease of more than 10%), the price could be re-negotiated between the parties.

Currently, there is no prevailing Prescribed Rates and the Market Price is approximately RMB11,600/ton. The Company has been purchasing metallurgy accessories from independent third parties, but Molong Equipment has agreed to provide a discount of RMB500/ton for the supply of metallurgy accessories. Hence the supply price of metallurgy accessories charged by Molong Equipment to the Company is RMB11,100/ton (“Metallurgy Accessories Supply Price”).

Taking into account the above pricing basis such that the Metallurgy Accessories Supply Price is not less favourable than that offered by independent third parties, we consider that the Metallurgy Accessories Supply Price is fair and reasonable and is in the interests of the Company and the Independent Shareholders as a whole.

(ii) Payment term

The Company shall make payments to Molong Equipment in cash monthly in arrears.

(iii) Other significant term

Molong Equipment has agreed to be responsible for distributing metallurgy accessories to the Company, the costs of which would be borne by Molong Equipment; the Company has agreed to be responsible for the expenses for inspecting the metallurgy accessories delivered.

Having reviewed the relevant documents in respect of the terms provided by Molong Equipment and considered such cost saving benefits enjoyed by the Company as stated in the paragraph headed “Background and reasons for, and benefits of, the Continuing Connected Transactions” above, we concur with the Directors’ view that the Purchase of Metallurgy Accessories has been negotiated on an arm’s length basis and is on normal commercial terms, and that the terms of the Metallurgy Accessories Supply Agreement are fair and reasonable and are in the interests of the Company and the Independent Shareholders as a whole.

(c) *Sales of Scrap and Used Metals*

(i) Price

Pursuant to the Scrap and Used Metals Supply Agreement, it has been agreed that the price at which scrap and used metals are supplied to Molong Equipment by the Company will be as follows:

- (1) if the scrap and used metals are subject to any fixed rates prescribed by the relevant authorities of the PRC (“Prescribed Rates”), the unit price of the relevant scrap and used metals will adopt the Prescribed Rates. If the Prescribed Rates increase after Molong Equipment places its orders with the Company, the Prescribed Rates at the time of the placing of the order will be adopted. If the Prescribed Rates decrease after Molong Equipment places its orders but before delivery of scrap and used metals by the Company, the Prescribed Rates at the time of delivery will be adopted;
- (2) if the scrap and used metals are not subject to any Prescribed Rates, the price will be negotiated and agreed by both parties with reference to the Market Price (as defined below); and
- (3) the market price (“Market Price”) is the prevailing market price charged by the Company to independent third parties for scrap and used metals over the same period.

Under normal circumstances, the price of scrap and used metals could be adjusted once annually by reference to the actual price of the scrap and used metals of the previous year plus an amount calculated based on the price index published by Weifang City Statistics Bureau. Where the price of the relevant scrap and used metals suffer significant fluctuations (increase/decrease of more than 10%), the price could be re-negotiated between the parties.

Currently, there is no prevailing Prescribed Rates and the Market Price is approximately RMB1,930/ton and the supply price of scrap and used metals charged by the Company to Molong Equipment has been agreed to be RMB1,930/ton (“Scrap and Used Metals Supply Price”).

Taking into account the above pricing basis such that the Scrap and Used Metals Supply Price is not less favourable than that offered by independent third parties, we consider that the Scrap and Used Metals Supply Price is fair and reasonable and is in the interests of the Company and the Independent Shareholders as a whole.

(ii) Payment term

Molong Equipment shall make payments to the Company in cash monthly in arrears.

(iii) Other significant term

The Company has agreed to be responsible for the expenses for distributing scrap and used metals to Molong Equipment, and Molong Equipment has agreed to be responsible for the expenses for inspecting the scrap and used metals delivered.

Having reviewed the relevant documents including the Scrap and Used Metals Supply Agreement and the transaction records in respect of the sales of scrap and used metals by the Company and considered such additional income generated from sales of the Company's side products, we concur with the Directors' view that the Sales of Scrap and Used Metals has been negotiated on an arm's length basis and is on normal commercial terms, and that the terms of the Scrap and Used Metals Supply Agreement are fair and reasonable and are in the interests of the Company and the Independent Shareholders as a whole.

(iii) **Proposed Annual Caps for the Continuing Connected Transactions**

(a) *Purchase of Oil Well Pipe and Casing Billets*

The Directors expect that the aggregate annual amount of sales of oil well pipe and casing billets by Weihai Baolong to the Company under the Oil Well pipe and Casing Billets Supply Agreement is approximately RMB37,000,000 (equivalent to approximately HK\$35,577,000) for the two months ending 31 December 2005, RMB740,000,000 (equivalent to approximately HK\$711,538,000) and RMB925,000,000 (equivalent to approximately HK\$889,423,000) respectively for each of the two years ending 31 December 2007 (each, an "Oil Well Pipe and Casing Billets Annual Cap"). The Directors therefore proposed that the Oil Well Pipe and Casing Billets Annual Caps for the amount payable to Weihai Molong for two months ending 31 December 2005 and the two years ending 31 December 2007 shall be approximately RMB38,000,000 (equivalent to approximately HK\$36,538,000), RMB750,000,000 (equivalent to approximately HK\$721,153,000) and RMB930,000,000 (equivalent to approximately HK\$894,231,000) respectively.

We understand from the Directors that the Oil Well Pipe and Casing Billets Annual Caps were determined based on (i) the projected volume of special seamless oil well pipes and casing produced by the Company of approximately 10,000 tons, 210,000 tons and 310,000 tons respectively for the two months ending 31 December 2005 and each of the two years ending 31 December 2007; (ii) the projected amount of oil well pipe and casing billets to be consumed by the Company for the production of special seamless oil well pipes and casing for the two months ending 31 December 2005 and each of the two years ending 31 December 2007; (iii) the projected amount of oil well pipe and casing billets to be purchased by the Company from Weihai Baolong and (iv) the supply price of oil well pipe and casing billets of RMB3,700/ton which is based on the current prevailing market price of RMB3,800/ton less an agreed discount of RMB100/ton. For details of the calculation of the Oil Well Pipe and Casing Billets Annual Caps, please refer to page 8 of the Circular.

We also understand that such estimated annual purchases were determined by reference to the following bases and assumptions, including but not limited to: (i) the annual volume of special seamless oil well pipes produced by the Company being constant for the two years ending 31 December 2007; (ii) the construction of the new 250,000-ton special seamless oil well casing production facilities of the Company being completed at the end of 2005; (iii) the production capacity of oil well pipe and casing billets of Weihai Baolong being sufficient for the projected volume of oil well pipe and casing billets supplied to the Company; (iv) the expected production efficiency rate on the consumption of oil well pipe and casing billets to manufacture the special seamless oil well pipes and casing during the course of production being determined with reference to the historical production record; and (v) no changes in the prevailing market price of oil well pipe and casing billets during the two months ending 31 December 2005 and the two years ending 31 December 2007. After discussion with the management of the Company and reviewing the information provided by the Company, we consider that the above bases and assumptions are reasonable.

In light of the above, we consider that the Oil Well Pipe and Casing Billets Annual Caps have been determined after arm's length negotiation and are fair and reasonable and in the interests of the Company and the Independent Shareholders as a whole.

(b) *Purchase of Metallurgy Accessories*

The Directors expect that the aggregate annual amount of sales of metallurgy accessories by Molong Equipment to the Company under the Metallurgy Accessories Supply Agreement is approximately RMB21,404,000 (equivalent to approximately HK\$20,581,000) and RMB25,760,000 (equivalent to approximately HK\$24,769,000) (each, a "Metallurgy Accessories Annual Cap") respectively for each of the two years ending 31 December 2007. The Directors therefore proposed that the Metallurgy Accessories Annual Caps for the amount payable to Molong Equipment for each of the two years ending 31 December 2007 shall be approximately RMB22,000,000 (equivalent to approximately HK\$21,154,000) and RMB27,000,000 (equivalent to approximately HK\$25,962,000) respectively.

We understand from the Directors that the Metallurgy Accessories Annual Caps were determined based on (i) the respective metallurgy accessories required for the production of special seamless oil well pipes and casing for each of the two years ending 31 December 2007 and (ii) the market prices of the respective metallurgy accessories required for the production special seamless oil well pipes and casing for each of the two years ending 31 December 2007. For details of the calculation of the Metallurgy Accessories Annual Caps, please refer to page 12 of the Circular.

We also understand that such estimated annual purchases were determined by reference to the following bases and assumptions, including but not limited to: (i) projected annual volume of the special seamless oil well pipes and casing produced by the Company of approximately 10,000 tons, 210,000 tons and 310,000 tons respectively for the two months ending 31 December 2005 and each of the two years ending 31 December 2007; (ii)

the production capacity of metallurgy accessories of Molong Equipment of approximately 2,500 tons being sufficient for the projected volume of the respective metallurgy accessories supplied to the Company for its production of special seamless oil well pipes and casing; (iii) the expected depletion of metallurgy accessories during the course of production being determined with reference to the historical production record; and (iv) no significant fluctuation of the market prices of the respective metallurgy accessories required for the production of special seamless oil well pipes and casing during the two years ending 31 December 2007. After discussion with the management of the Company and reviewing the information provided by the Company, we consider that the above bases and assumptions are reasonable.

In light of the above, we consider that Metallurgy Accessories Annual Caps have been determined after arm's length negotiation and are fair and reasonable and in the interests of the Company and the Independent Shareholders as a whole.

(c) *Supply of Scrap and Used Metals*

The Directors expect that the aggregate annual amount of sales of scrap and used metals to Molong Equipment by the Company under the Scrap and Used Metals Supply Agreement is approximately RMB4,825,000 (equivalent to approximately HK\$4,639,000) for the two months ending 31 December 2005, RMB18,914,000 (equivalent to approximately HK\$18,187,000) and RMB28,178,000 (equivalent to approximately HK\$27,094,000) respectively for each of the two years ending 31 December 2007 (each, a "Scrap and Used Metals Annual Cap"). The Directors therefore proposed that the Scrap and Used Metal Annual Caps for the amount payable to the Company by Molong Equipment for two months ending 31 December 2005 and for each of the two years ending 31 December 2007 shall be approximately RMB5,000,000 (equivalent to approximately HK\$4,808,000), RMB19,200,000 (equivalent to approximately HK\$18,462,000) and RMB28,200,000 (equivalent to approximately HK\$27,115,000).

We understand from the Directors that the Scrap and Used Metals Annual Caps were determined based on (i) the projected annual volume of the special seamless oil well pipes and casing produced by the Company of approximately 10,000 tons, 210,000 tons and 310,000 tons respectively for the two months ending 31 December 2005 and each of the two years ending 31 December 2007; (ii) the projected volume of scrap and used metals generated during the course of production on the consumption of oil well pipe and casing billets of approximately 450 tons, 9,800 tons and 14,600 tons respectively for the two months ending 31 December 2005 and each of the two years ending 31 December 2007; and (iii) the projected scrap and used metals to be supplied by the Company to Molong Equipment for the two months ending 31 December 2005 and each of the two years ending 31 December 2007. For details of the calculation of the Scrap and Used Metals Annual Caps, please refer to page 16 of the Circular.

We also understand that such estimated annual sales were determined by reference to the following bases and assumptions, including but not limited to: (i) the annual volume of special seamless oil well pipes produced by the Company being constant for the two years ending 31 December 2007; (ii) the construction of the new 250,000-ton casing production facilities of the Company being completed at the end of 2005; (iii) the expected yield of scrap and used metals generated during the course of production on the consumption of oil well pipe and casing billets being determined with reference to the historical production record; and (iv) no significant fluctuation on the market price of scrap and used metals during the two years ending 31 December 2007. After discussion with the management of the Company and reviewing the information provided by the Company, we consider that the above bases and assumptions are reasonable.

In light of the above, we consider that the Scrap and Used Metals Annual Caps have been determined after arm's length negotiation and are fair and reasonable and in the interests of the Company and the Independent Shareholders as a whole.

## **CONNECTED TRANSACTION**

### **Principal reasons and factors considered**

In arriving at our recommendation to the Independent Board Committee and the Independent Shareholders in respect of the Connected Transaction, we have considered the following principal reasons and factors:

### **Background and reasons for, and benefits of, the Connected Transaction**

Pursuant to the Machinery Accessories Supply Agreement, Molong Equipment has agreed to sell and the Company has agreed to purchase machinery accessories (such as high pressure cupboards, low pressure electric appliances, electric appliances and related equipment sets) which is effective from the approval of the Independent Shareholders at the EGM.

The Company selected a supplier for the supply of the machinery accessories through a bidding process in July 2005, in which three suppliers (including Molong Equipment) participated. The bidding price from Molong Equipment is lower than those of the other suppliers. Therefore, the Company has decided to enter into the Machinery Accessories Supply Agreement with Molong Equipment for the supply of the machinery accessories.

Other than enjoying the lower bidding price from Molong Equipment which can reduce the fixed cost of production of the Company (including the depreciation expenditure), under the Machinery Accessories Supply Agreement, the quality and technological standard of the machinery accessories supplied by Molong Equipment to the Company shall comply with the relevant national standard in the PRC. The Company also benefits from saving the distribution costs as Molong Equipment has agreed to be responsible for the expenses for distributing the machinery accessories to the Company.

In light of the above cost saving benefits and quality and technological standard assurance enjoyed by the Company, we consider that the supply of machinery accessories by Molong Equipment to the Company is in the interests of the Company and the Independent Shareholders as a whole.

**Consideration of the acquisition of machinery accessories from Molong Equipment**

Pursuant to the Machinery Accessories Supply Agreement, it has been agreed that the aggregate price at which the machinery accessories are supplied to the Company by Molong Equipment is RMB33,000,000 (equivalent to approximately HK\$31,731,000) (“Supply Price”) which is determined with reference to the prevailing market price and is not higher than that of the same products sold by Molong Equipment to independent third parties in its normal course of business over the same period. A buffer of not more than 5% in excess of the Company’s expected total value of the purchase from Molong Equipment has been taken into account for reaching the Supply Price.

Having considered the above pricing basis and that the bidding price from Molong Equipment is lower than those of the other suppliers, we are of the view that the Supply Price is fair and reasonable so far as the Company and the Independent Shareholders are concerned.

**Terms of the acquisition of machinery accessories from Molong Equipment**

Other significant terms of the Machinery Accessories Supply Agreement include:

- (1) Molong Equipment shall deliver the machinery accessories to the Company on the dates specified in the Machinery Accessories Supply Agreement;
- (2) the quality and technological standard of the machinery accessories supplied by Molong Equipment to the Company shall comply with the relevant national standard in the PRC; and
- (3) Molong Equipment has agreed to be responsible for the expenses for distributing the machinery accessories to the Company; and the Company has agreed to be responsible for the expenses for inspecting the machinery accessories delivered.

Having reviewed the relevant documents in respect of the terms provided by Molong Equipment, we consider that the Machinery Accessories Supply Agreement has been negotiated on an arm’s length basis and on normal commercial terms, and that the terms of the Machinery Accessories Supply Agreement are fair and reasonable and are in the interest of the Company and the Independent Shareholders as a whole.



**RECOMMENDATION**

Taking into consideration of the above principal reasons and factors, we are of the opinion that the Continuing Connected Transactions, the Annual Caps and the Connected Transaction are in the interests of the Company and the Independent Shareholders as a whole and the terms of which are fair and reasonable so far as the Company and the Independent Shareholders are concerned. Accordingly, we advise the Independent Board Committee and the Independent Shareholders that the Independent Shareholders should vote in favour of the ordinary resolutions to be proposed at the EGM to approve the Continuing Connected Transactions, the Annual Caps and the Connected Transaction.

Yours faithfully,  
**For and on behalf of**  
**China Everbright Capital Limited**  
**Jacky Ho**  
*Executive Director*

## **1. RESPONSIBILITY STATEMENT**

This circular includes particulars given in compliance with the GEM Listing Rules for the purpose of giving information with regard to the Company. The Directors collectively and individually accept full responsibility for the accuracy of the information contained in this circular and confirm, having made all reasonable enquiries, that to the best of their knowledge and belief:

- (a) the information contained in this circular is accurate and complete in all material respects and not misleading;
- (b) there are no other matters the omission of which would make any statement in this circular misleading; and
- (c) all opinions expressed in this circular have been arrived at after due and careful consideration and are founded on bases and assumptions that are fair and reasonable.

## **2. DISCLOSURE OF INTERESTS**

### **Directors', Supervisors' and Chief Executive's Interests in Shares, Underlying Shares and Debentures**

As at the Latest Practicable Date, the interests and positions of the Directors, Supervisors and chief executive of the Company in the shares, debentures or underlying shares of the Company and any of its associated corporations (within the meaning of Part XV of the Securities and Futures Ordinance (“SFO”)), which will be required to be notified to the Company and the Stock Exchange pursuant to Divisions 7 and 8 of Part XV of the SFO (including interests or short positions which they are taken or deemed to have under such provisions of the SFO) or which will be required, pursuant

## APPENDIX — GENERAL INFORMATION

to section 352 of the SFO, to be entered in the register referred to therein, or which will be required pursuant to rules 5.46 to 5.67 of the GEM Listing Rules, to be notified to the Company and the Stock Exchange, will be as follows:

Long positions in the domestic shares of the Company:

		Number of domestic shares <i>(note)</i>	Approximate percentage of total issued domestic share capital <i>(%)</i>	Approximate percentage of total issued share capital <i>(%)</i>
	Type of interest			
Zhang En Rong	Personal	279,517,000	69.58%	43.14%
Lin Fu Long	Personal	34,216,000	8.52%	5.28%
Zhang Yun San	Personal	30,608,000	7.62%	4.72%
Xie Xin Cang	Personal	21,410,000	5.33%	3.30%

*Note:* Unlisted shares

Save as disclosed above, as at the Latest Practicable Date, none of the Directors, Supervisors or chief executive of the Company nor their associates had any interest and short positions in the shares, underlying shares or debentures of the Company or any of its associated corporations (within the meaning of Part XV of the SFO) which would have to be notified to the Company and the Stock Exchange under the provisions of Divisions 7 and 8 of Part XV of the SFO or pursuant to section 352 of the SFO, to be entered in the register referred to therein or which were required to be notified to the Company and the Stock Exchange pursuant to rules 5.46 to 5.67 of the GEM Listing Rules.

### Sponsor's Interests

Neither the Sponsor nor any of its directors, employees or associates (as referred to in Note 3 to GEM Listing Rule 6.35) had any interests in the securities of the Company or any right to subscribe for or to nominate persons to subscribe for the securities of the Company or any member of the Group. The Company was also informed by the Sponsor that none of the Sponsor or its directors, employees, associates (as referred to in GEM Listing Rule 6.36) has any competing interest.

Pursuant to the sponsorship agreement dated 29 March, 2004 and entered into between the Company and the Sponsor, the Sponsor has been appointed as the sponsor of the Company for the remainder of the year ended 31 December, 2004 and for the period of two years thereafter until 31 December, 2006 and the Sponsor is entitled to receive an agreed amount of fee for its provision of services.

### **Directors' and Supervisors' Interest in Any Asset Acquired, Disposed or Leased**

None of the Directors and Supervisors has any material interest, direct or indirect, in any asset which, since 31 December 2004, being the date to which the latest audited consolidated financial statements of the Group have been made up, had been acquired or disposed of by or leased to any member of the Group or was proposed to be acquired or disposed of by or leased to any member of the Group.

### **Directors' and Supervisors' Service Contract**

Each of the Directors and Supervisors has entered into a service contract with the Company. Particulars of these contracts, except as indicated, are in all material respects identical and set out below:

- (i) each service contract is for an initial term of three years commencing from the date of the signing of the service contract and may be renewed thereunder subject to the approval of the Shareholders' meeting of the Company;
- (ii) subject to resolution passed at the Shareholders' meeting of the Company, the remuneration of each of the Directors and Supervisors may be changed;
- (iii) each of the Directors and Supervisors is entitled to out-of-pocket expenses reasonably incurred during his/her term of office;
- (iv) the actual salary payable to each of the executive Directors is subject to adjustment dependent upon the results of the internal review of the executive Directors concerned; and
- (v) each of the executive Directors is entitled to such bonus as decided by the Board, calculated by reference to the operating results of the Company as a whole and the performance of the executive Directors.

Save as disclosed above, none of the Directors has or is proposed to have a service contract with the Company or any of its subsidiaries in the capacity of a director which is not determinable by the Group within one (1) year without the payment of compensation other than statutory compensation.

### **Directors' and Supervisors' Interest in Contracts**

No contracts of significance to which the Company, any of its holding companies, fellow subsidiaries or subsidiaries was a party and in which a Director or a Supervisor has a material interest and which is significant to the Group's business, whether directly or indirectly, subsisted at the date of this circular. None of the Directors or their respective associates has any competing interest (as would be required to be disclosed under Rule 8.10 of the Listing Rules if each of them were a controlling shareholder of the Company for the purpose of the Listing Rules).

## APPENDIX — GENERAL INFORMATION

### Substantial Shareholders

As at the Latest Practicable Date, so far as is known to any Directors, Supervisors or chief executive of the Company, the following persons (other than a Director, Supervisor or chief executive of the Company) had, or were deemed or taken to have interests or short positions in the shares or underlying shares and debentures of the Company which would fall to be disclosed to the Company and the Stock Exchange under the provisions of Divisions 2 and 3 of Part XV of the SFO and required to be entered in the register maintained by the Company pursuant to section 336 of the SFO:

Name	Type of interests	Number of shares	Percentage of domestic shares	Percentage of H shares	Percentage of total registered capital
Zhang Xiu Lan ( <i>Note 1</i> )	Interests of spouse	279,517,000	69.58%	—	43.14%
Li Xiu Fen ( <i>Note 2</i> )	Interests of spouse	34,216,000	8.52%	—	5.28%
Zhang Xin Lan ( <i>Note 3</i> )	Interests of spouse	30,608,000	7.62%	—	4.72%
Li Bao Hui ( <i>Note 4</i> )	Interests of spouse	21,410,000	5.33%	—	3.30%
Peter Cundill & Associates					
(Bermuda) Ltd. ( <i>Note 5</i> )	Investment manager	76,760,000	—	31.17%	11.8%
RAB Energy Fund					
Limited ( <i>Note 5</i> )	Investment manager	33,832,000	—	13.74%	5.22%
Cheah Cheng Hye ( <i>Note 5</i> )	Corporate interest controlled by the significant shareholder	22,178,000	—	9.01%	3.42%
Value Partners Limited ( <i>Note 5</i> )	Investment manager	22,178,000	—	9.01%	3.42%
Commonwealth Bank of Australia ( <i>Note 5</i> )	Corporate interest controlled by the significant shareholder	13,052,000	—	5.30%	2.01%

Note 1: Zhang Xiu Lan is the wife of Zhang En Rong and is taken to be interested in the 279,517,000 domestic shares held by Zhang En Rong under the SFO.

Note 2: Li Xiu Fen is the wife of Lin Fu Long and is taken to be interested in the 34,216,000 domestic shares held by Lin Fu Long under the SFO.

Note 3: Zhang Xin Lan is the wife of Zhang Yun San and is taken to be interested in the 30,608,000 domestic shares held by Zhang Yun San under the SFO.

Note 4: Li Bao Hui is the wife of Xie Xin Cang and is taken to be interested in the 21,410,000 domestic shares held by Xie Xin Cang under the SFO.

Note 5: Interests in H shares.

Save as disclosed above, so far as is known to the Directors, Supervisors or chief executive of the Company, no other person (not being a Director, Supervisors or chief executive of the Company) had any interests or short positions in shares or underlying shares of the Company which would fall to be disclosed to the Company and the Stock Exchange, under the provisions of Divisions 2 and 3 of Part XV of the SFO and required to be entered in the register maintained by the Company pursuant to section 336 of the SFO.

### **3. MATERIAL ADVERSE CHANGE**

The Directors are not aware of any material adverse change in the financial position or trading prospects of the Group since 31 December 2004, the date to which the latest audited financial statements of the Group were made up.

### **4. LITIGATION**

As at the Latest Practicable Date, neither the Company nor any of its subsidiaries was engaged in any litigation or arbitration of material importance and no litigation, arbitration or claim of material importance was known to the Directors to be pending or threatened by or against the Company or any of its subsidiaries.

### **5. CONSENT AND EXPERT**

The following is the qualification of the professional adviser who has given opinion or advice, which is contained in this circular:

<b>Name</b>	<b>Qualification</b>
China Everbright Capital Limited	Licensed under the SFO for type 1 (dealing in securities) and type 6 (advising on corporate finance) as defined under the SFO

China Everbright Capital Limited has given and has not withdrawn its written consent to the issue of this circular with the inclusion of its letter and the references to its name in the form and context in which it appears.

As at the Latest Practicable Date, (i) China Everbright Capital Limited did not have any interest, either direct or indirect, in any assets which have been, since the date to which the latest published audited financial statements of the Company were made up, acquired or disposed of by, or leased to any member of the Group or are proposed to be acquired or disposed of by, or leased to, any member of the Group and (ii) China Everbright Capital Limited did not have any shareholding interests, beneficially or non-beneficially, in any member of the Group and it did not have any right, whether legally enforceable or not, to subscribe for or nominate any persons to subscribe for securities of any members of the Group.

**6. DOCUMENTS FOR INSPECTION**

Copies of the following documents will be available for inspection at the office of Coudert Brothers on the 39th Floor, Gloucester Tower, The Landmark, 11 Pedder Street, Central, Hong Kong during normal business hours on any weekday (except public holidays) from the date of this circular up to and including 21 October 2005:

- (a) the letter of recommendation from the Independent Board Committee, the text of which is set out on page 23 of this circular;
- (b) the letter issued by China Everbright Capital Limited, the text of which is set out on pages 24 to 38 of the circular;
- (c) the service contracts of the Directors and Supervisors referred to in paragraph headed “Directors” and Supervisors’ Service Contracts” of this appendix;
- (d) the Oil Well Pipe and Casing Billets Supply Agreement;
- (e) the Metallurgy Accessories Supply Agreement;
- (f) the Scrap and Used Metals Supply Agreement; and
- (g) the Machinery Accessories Supply Agreement.

**7. MISCELLANEOUS**

- (i) The legal address of the Company is at No. 99 Beihai Road, Shouguang City, Shandong Province, The People’s Republic of China.
- (ii) The address of the head office of the Company is No. 99 Beihai Road, Shouguang City, Shandong Province, The People’s Republic of China.
- (iii) The principal place of business of the Company in Hong Kong is Suite F, 10th Floor, Ho Lee Commercial Building, 38-44 D’Aguilar Street, Central, Hong Kong.
- (iv) The Company’s branch share registrar and transfer office in Hong Kong is Tricor Investor Services Limited at Ground Floor, Bank of East Asia Harbour View Centre, 56 Gloucester Road, Wanchai, Hong Kong.
- (v) The secretary and the qualified accountant of the Company is Mr. Chan Wing Nang, Billy.
- (vi) In the event of inconsistency, the English language text of this circular shall prevail over the Chinese language text.



# 山東墨龍石油機械股份有限公司

Shandong Molong Petroleum Machinery Company Limited

*(A Sino-foreign joint stock limited company incorporated in the People's Republic of China with limited liability)*

**(Stock Code: 8261)**

## NOTICE OF THE EXTRAORDINARY GENERAL MEETING

**NOTICE IS HEREBY GIVEN** that an extraordinary general meeting (the “EGM”) of Shandong Molong Petroleum Machinery Company Limited (the “Company”) will be held at 3:00 p.m. on Monday, 28 November 2005 at No. 99 Beihai Road, Shouguang City, Shandong Province, The People’s Republic of China, for the purpose of considering and, if thought fit, approving the following ordinary resolutions:

1. **“THAT** a conditional agreement (the “**Oil Well Pipe and Casing Billets Supply Agreement**”) entered into between the Company and 威海寶隆石油專材有限公司 (Weihai Baolong Special Petroleum Company Limited) (“**Weihai Baolong**”) on 22 September 2005 in relation to the supply of oil well pipe and casing billets to the Company by Weihai Baolong for a term from 28 November 2005 to 31 December 2007, the continuing connected transactions contemplated thereunder and the proposed annual caps for the continuing connected transactions contemplated thereunder, be and are hereby approved, confirmed and ratified; and any director of the Company be and is hereby authorized to execute the Oil Well Pipe and Casing Billets Supply Agreement and do such other acts and things and execute such other documents which in his opinion may be necessary or desirable to implement the Oil Well Pipe and Casing Billets Supply Agreement for and on behalf of the Company.”
2. **“THAT** a conditional agreement (the “**Metallurgy Accessories Supply Agreement**”) entered into between the Company and 壽光墨龍機電設備有限公司 (Shouguang Molong Electro-mechanical Equipment Company Limited) (“**Molong Equipment**”) on 22 September 2005 in relation to the supply of metallurgy accessories to the Company by Molong Equipment for a term from 28 November 2005 to 31 December 2007, the continuing connected transactions contemplated thereunder and the proposed annual caps for the continuing connected transactions contemplated thereunder, be and are hereby approved, confirmed and ratified; and any director of the Company be and is hereby authorized to execute the Metallurgy Accessories Supply Agreement and do such other acts and things and execute such other documents which in his opinion may be necessary or desirable to implement the Metallurgy Accessories Supply Agreement for and on behalf of the Company.”
3. **“THAT** a conditional agreement (the “**Scrap and Used Metals Supply Agreement**”) entered into between the Company and Molong Equipment on 22 September 2005 in relation to the supply of scrap and used metals by the Company to Molong Equipment for a term from 28 November 2005 to 31 December 2007, the continuing connected transactions contemplated thereunder and the proposed annual caps for the continuing



## NOTICE OF EXTRAORDINARY GENERAL MEETING

connected transactions contemplated thereunder, be and are hereby approved, confirmed and ratified; and any director of the Company be and is hereby authorized to execute the Scrap and Used Metals Supply Agreement and do such other acts and things and execute such other documents which in his opinion may be necessary or desirable to implement the Scrap and Used Metals Supply Agreement for and on behalf of the Company.”

4. **“THAT** a conditional agreement (the **“Machinery Accessories Supply Agreement”**) entered into between the Company and Molong Equipment on 22 September 2005 in relation to the supply of machinery accessories to the Company by Molong Equipment with effect from 28 November 2005 and the connected transactions contemplated thereunder, be and are hereby approved, confirmed and ratified; and any director of the Company be and is hereby authorized to execute the Machinery Accessories Supply Agreement and do such other acts and things and execute such other documents which in his opinion may be necessary or desirable to implement the Machinery Accessories Supply Agreement for and on behalf of the Company.”

By Order of the Board  
**Shandong Molong Petroleum Machinery  
Company Limited**  
**Chan Wing Nang, Billy**  
*Company Secretary*

7 October 2005  
Shandong  
The People’s Republic of China

*Notes:*

- (A) The H Share register of the Company will be closed from 28 October 2005 to 28 November 2005 (both days inclusive), during which no transfer of H Shares will be effected. Any holders of H Shares of the Company, whose names appear on the Company’s register of members at the close of business on 27 October 2005, are entitled to attend and vote at the EGM after completing the registration procedures for attending the meeting. In order to be entitled to attend and vote at the EGM, share transfer documents should be lodged with the Company’s H share registrar not later than 4:00 p.m. on 27 October 2005.

The address of the share registrar for the Company’s H Shares is as follows:

Ground Floor,  
Bank of East Asia Harbour View Centre  
56 Gloucester Road  
Hong Kong

# NOTICE OF EXTRAORDINARY GENERAL MEETING

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- (B) Holders of H Shares and Domestic Shares, who intend to attend the EGM, must complete the reply slips for attending the EGM and return them to the registered office of the Company not later than 20 days before the date of the EGM, i.e. no later than 8 November 2005.

Details of the registered office of the Company are as follows:

No.99 Beihai Road  
Shouguang City  
Shandong Province  
The People's Republic of China

- (C) Each holder of H Shares who has the right to attend and vote at the EGM is entitled to appoint in writing one or more proxies, whether a shareholder or not, to attend and vote on his behalf at the EGM. A proxy of a shareholder who has appointed more than one proxy may only vote on a poll.
- (D) The instrument appointing a proxy must be in writing under the hand of the appointor or his attorney duly authorised in writing. If that instrument is signed by an attorney of the appointor, the power of attorney authorising that attorney to sign, or other documents of authorisation, must be notarially certified.
- (E) To be valid, the form of proxy, and if the form of proxy is signed by a person under a power of attorney or other authority on behalf of the appointor, a notarially certified copy of that power of attorney or other authority, must be delivered to the Company's H Shares share registrar, Tricor Investor Services Limited, at Ground Floor, Bank of East Asia Harbour View Centre, 56 Gloucester Road, Hong Kong, not less than 24 hours before the time for holding the EGM or any adjournment thereof in order for such documents to be valid.
- (F) Each holder of Domestic Shares is entitled to appoint in writing one or more proxies, whether a shareholder or not, to attend and vote on its behalf at the EGM. Notes (C) to (D) also apply to holders of Domestic Shares, except that the proxy form or other documents of authority must be delivered to the Office of the Secretary to the Board of Directors, the address of which is set out in Note (B) above, not less than 24 hours before the time for holding the EGM or any adjournment thereof in order for such documents to be valid.
- (G) If a proxy attends the EGM on behalf of a shareholder, he should produce his ID card and the instrument signed by the proxy or his legal representative, which specifies the date of its issuance. If the legal representative of a legal person share shareholder attends the EGM, such legal representative should produce his/her ID card and valid documents evidencing his capacity as such legal representative. If a legal person share shareholder appoints a representative of a company other than its legal representative to attend the EGM, such representative should produce his ID card and an authorization instrument affixed with the seal of the legal person share shareholder and duly signed by its legal representative.
- (H) The EGM is expected to last for half a day. Shareholders attending the EGM are responsible for their own transportation and accommodation expenses.