

Management Discussion and Analysis

Outlook

The oil industry will continue to face uncertainties in 2002. Destabilizing factors such as those related to the global political and economic environment may cause fluctuations in global oil prices and thereby negatively affect our development. However, the continued steady growth and momentum of the Chinese economy in which there is a continued growing demand for energy has provided an environment for our rapid development.

We have drawn up a practical and progressive business development plan for 2002 based on a careful analysis by our management of the dynamics affecting the development of the Chinese and global economy and oil industry. Firstly, we will focus on actively developing our current reserves to increase oil production. We will also expand our exploration efforts in Chinese coastal waters, particularly in relation to natural gas, in order to increase reserves as well as prepare a firm foundation for the next phase of development. Secondly, we will strive to maintain a low cost structure that will allow us to thrive even in an environment of low oil prices.

In 2002, three of our oil fields in Chinese coastal waters are scheduled to come onstream. Additionally, we announced in January 2002 the acquisition of certain Indonesian oil and gas assets owned by Repsol YPF. These developments will further increase our production in this year.

With the continued efforts of our management and employees and our solid financial position, our management believes that the outlook remains positive for 2002.

Consolidated Profit

Our consolidated profit before tax for 2001 was RMB11,005.9 million (US\$1,329.8 million), a decrease of 10% from RMB12,222.7 million (US\$1,476.8 million) in 2000. This decrease was primarily due to the fall in crude oil prices. Our crude oil price is fixed by reference to international crude oil prices. There was a significant fall in international crude oil prices in 2001 compared to 2000.

Profit after tax for 2001 was RMB7,957.6 million (US\$961.5 million), a decrease of 23% from RMB10,296.6 million (US\$1,244.1 million) in 2000. This decrease was primarily due to the fall in oil prices and the change in the enterprise income tax rate. The preferential enterprise income tax rate enjoyed by our PRC subsidiary ceased to apply after 2000 and the applicable enterprise income tax rate was adjusted from the 15% preferential rate to the normal rate of 30% with effect from the year 2001. Provision for taxation in 2001 was RMB3,048.2 million (US\$368.3 million), an increase of RMB1,122.1 million (US\$135.6 million) or 58.3% from RMB1,926.1 million (US\$232.7 million) in 2000.

Turnover

Oil and gas sales for 2001 were RMB17,560.8 million (US\$2,121.7 million), a decrease of RMB1,258.5 million (US\$152.1 million) or 6.7%, from RMB18,819.3 million (US\$2,273.8 million) in 2000. Due to lower oil prices, our oil and gas sales decreased by approximately RMB3,351.5 million (US\$404.9 million), which was partially offset by an increase in oil and gas sales of approximately RMB2,093.0 million (US\$252.9 million) due

to increased oil and gas production in 2001. Our net realized crude oil price averaged US\$23.34 per barrel in 2001, a decrease of US\$4.87 or 17.3%, from US\$28.21 per barrel in 2000, due to the decrease in international oil prices. Our net realized natural gas price averaged US\$3.08 per thousand cubic feet in 2001, which was almost the same as the price of US\$3.09 per thousand cubic feet in 2000. Our net crude oil and condensate production in 2001 averaged approximately 228,874 barrels per day, rising 22,527 barrels per day or 10.9% compared with 206,347 barrels per day in 2000. The increase in production primarily resulted from new oil fields commencing production during 2001, including Suizhong 36-1 (phase II), Qikou 17-2 and Qinhuangdao 32-6. Net natural gas production in 2001 averaged 195.0 million cubic feet per day, a slight decrease of approximately 2.9 million cubic feet or 1.5%, from 197.9 million cubic feet per day in 2000. The primary reason for the decrease was that the higher thermal capacity of Yacheng 13-1 natural gas resulted in slightly lower consumption of natural gas by the user.

Other income was RMB721.7 million (US\$87.2 million) in 2001, an increase of RMB443.1 million (US\$53.5 million) or 159.0%, compared with RMB278.6 million (US\$33.7 million) in 2000. The increase was mainly due to the increase in project management fees and handling fees for production sharing contract blocks.

Expenses

Operating expenses for 2001 were RMB2,329.1 million (US\$281.4 million), an increase of RMB205.0 million (US\$24.8

million) or 9.7%, from RMB2,124.1 million (US\$256.6 million) in 2000. The increase was primarily due to new oil and gas fields commencing production in 2001. Although production for the same period increased by 9.2% compared to 2000, on a unit of production basis, our operating expenses in 2001 were RMB24.9 (US\$3.01) per barrel-of-oil equivalent, such figure being almost the same as the 2000 figure of RMB24.76 (US\$2.99) per barrel-of-oil equivalent.

Production taxes for 2001 were RMB883.8 million (US\$106.8 million), a decrease of RMB152.9 million (US\$18.5 million) or 14.7%, from RMB1,036.7 million (US\$125.3 million) in 2000, due to the drop in oil prices in 2001.

Exploration costs for 2001 were RMB1,039.3 million (US\$125.6 million), an increase of RMB486.4 million (US\$58.8 million) or 88.0 %, from RMB552.9 million (US\$66.8 million) in 2000, primarily due to the higher investment made in significantly increasing exploration work in 2001 and the writing off of expenses associated with exploration work on wells for uncertain reserves in earlier years.

Depreciation, depletion and amortization expenses for 2001 was RMB2,566.9 million (US\$310.1 million), a decrease of RMB11.0 million (US\$1.4 million) or 0.4%, from RMB2,577.9 million (US\$311.5 million) in 2000. The 2001 figure was almost the same as the 2000 figure. On a per unit basis, depreciation, depletion and amortization expenses was RMB27.5 per barrel-of-oil equivalent (US\$3.32 per barrel-of-oil equivalent), a decrease of 8.3% as compared to RMB30.0 per

barrel-of-oil equivalent (US\$3.63 per barrel-of-oil equivalent) in 2000. The primary reason for the decrease was that the increase in proven reserves in some high-production oil and gas fields resulted in a decrease in the unit depreciation, depletion and amortization cost of those fields, thereby leading to the decrease in our total depreciation, depletion and amortization cost.

Dismantlement and site restoration allowance for 2001 was RMB90.4 million (US\$10.9 million), a decrease of RMB13.2 million (US\$1.6 million) or 12.7%, from RMB103.6 million (US\$12.5 million) in 2000 due to full provision of the allowance for certain mature fields in earlier years.

Impairment losses related to oil and gas assets were RMB99.7 million (US\$12.0 million), which reflected the estimated impairment resulting from two oil fields not being expected to fully recover their net book values through future cash flows.

Crude oil and product purchases for 2001 were RMB2,453.3 million (US\$296.4 million), a decrease of RMB2,644.5 million (US\$319.5 million) or 51.9%, from RMB5,097.8 million (US\$615.9 million) in 2000. Upon request by our foreign partners, we purchase their share of crude oil for resale in China, since we are one of the only three companies authorized to market and sell crude oil in the PRC. We do not have control over our foreign partners' decisions regarding the sale of their share of production and, therefore, have no control over the volume that we may be asked to handle in any particular period.

Selling and administrative expenses for 2001 were RMB615.4 million (US\$74.4 million), an increase of RMB159.4 million (US\$19.3 million) or 35.0%, from RMB456.0 million (US\$55.1 million) in 2000. On a unit of production basis, selling and administrative expenses were RMB6.6 (US\$0.80) per barrel-of-oil equivalent of production in 2001, an increase of 25% from RMB5.3 (US\$0.64) per barrel-of-oil equivalent in 2000. The increase was primarily due to a combination of the following factors: in 2000, there was a recovery of RMB57.7 million in doubtful accounts which led to lower expenses for 2000; in 2001, we made a RMB40.0 million provision for staff and workers bonus and welfare funds in accordance with a resolution of our board of directors, there was an increase of salary and staff benefits as a result of employee compensation reform; there was also an increase of public facilities, office administrative, telecommunication and travelling expenses as a result of greater business volumes and higher office rents.

Net interest income for 2001 was RMB201.1 million (US\$24.3 million), increase RMB439.5 million (US\$53.1 million) or 184.4%, from net interest expense of RMB238.4 million (US\$28.8 million) in 2000, primarily due to an increase in interest income resulting from significantly higher cash balances after our listing and lower interest expenses resulting from lower outstanding balances in respect of long-term indebtedness.

Exchange gain for 2001 was RMB235.4 million (US\$28.4 million), a decrease of RMB145.9 million (US\$17.6 million) compared to RMB381.3 million (US\$46.1 million) in 2000. The exchange gain or loss

Management Discussion and Analysis (Cont'd)

in each period mainly represents foreign exchange gains or losses on our Japanese yen denominated debt resulting from the depreciation or appreciation of Japanese yen against Renminbi.

Other expenses for 2001 were RMB517.9 million (US\$62.6 million), an increase of RMB300.3 million (US\$36.3 million) compared to RMB217.6 million (US\$26.3 million) in 2000, primarily due to the increase in expenses related to project management for production sharing contracts and the provision of services for areas covered by production sharing contracts.

Investment income for 2001 was RMB220.7 million (US\$26.7 million), which represented the income generated from investing the unused net proceeds from our IPO in low risk short term money market funds.

Share of profit of associated company for 2001 was RMB90.0 million (US\$10.9 million), a decrease of RMB128.3 million (US\$15.5 million) or 58.8%, compared to RMB218.3 million (US\$26.4 million) in 2000. This item reflected our share of profit generated by Shanghai Petroleum and Natural Gas Company Limited. This company suffered a decrease in profit in 2001 as compared to 2000 primarily due to an increase in its exploration costs and an increase in its amortization cost resulting from lower proven reserves, as well as a decline in 2001 in the realised price of its condensate.

Net non-operating income in 2001 was RMB34.9 million (US\$4.2 million), an increase of RMB230.9 million (US\$27.9

million) from net non-operating loss of RMB196.0 million (US\$23.7 million) in 2000, primarily due to the losses incurred in the disposal of certain assets in 2000.

Provision for taxation in 2001 was RMB3,048.2 million (US\$368.3 million), an increase of RMB1,122.1 million (US\$135.6 million) or 58.3%, from RMB1,926.1 million (US\$232.7 million) in 2000. The primary reason for the increase was that the period for which our PRC subsidiary enjoyed preferential enterprise income tax treatment expired after 2000 and the applicable enterprise income tax rate for our PRC subsidiary was adjusted from 15% to the normal rate of 30% with effect from 2001.

Cash Provided by Operations and Working Capital

Cash provided by operating activities in 2001 decreased by RMB404.7 million (US\$48.9 million) or 2.8% to RMB14,025.0 million (US\$1,694.5 million), from RMB14,429.7 million (US\$1,743.4 million) in 2000. The decrease resulted primarily from a decrease in profit before tax of RMB1,216.8 million (US\$147.0 million), a decrease in net interest expenses of RMB439.5 million (US\$53.1 million) and an increase in short-term investment gains of RMB220.7 million (US\$26.7 million). The decrease in the cash flow was partly offset by a non-cash written off of exploration dry hole expenses, and disposal of fixed assets of RMB456.8 million (US\$55.2 million) non-cash impairment losses related to oil and gas assets of RMB99.7 million (US\$12.0 million), a decrease in share of profit of an associated company of RMB128.3 million (US\$15.5 million) and a decrease in

unrealized foreign exchange gain of RMB62.9 million (US\$7.6 million).

In addition, our operating cash flow was affected by a net decrease in working capital. The decrease in working capital resulted from an increase in accounts payable and accrued liabilities of RMB267.7 million (US\$32.3 million) and a decrease in accounts receivable and other current assets of RMB314.9 million (US\$38.0 million)

We had a working capital surplus of RMB15,638.5 million (US\$1,889.5 million) as at December 31, 2001, up RMB14,934.3 million (US\$1,804.4 million) compared to RMB704.2 million (US\$85.1 million) in 2000. The increase in net working capital mainly resulted from proceeds of RMB10,101.6 million (US\$1,220.5 million) received from our initial public offering in 2001, a decrease in dividends payable of RMB3,397.3 million (US\$410.5 million) and a decrease in retirement funds payable to our parent company of RMB1,657.0 million (US\$200.2 million). These were partially offset by an increase in accounts payable and accrued liabilities of RMB404.8 million (US\$48.9 million), an increase of RMB234.3 million (US\$28.3 million) in current portion of long term bank loans and a decrease in accounts receivable and other receivable amounts of RMB274.5 million (US\$33.2 million).

Capital Expenditures and Investments

Our total capital expenditures were RMB4,342.6 million (US\$524.7 million) in 2001, a decrease of RMB61.4 million (US\$7.4 million) or 1.4%, from

RMB4,404.0 million (US\$532.1 million) in 2000. Our capital expenditures in 2001 consisted of RMB311.5 million (US\$37.6 million) for capitalized exploration activities and RMB4,013.1 million (US\$484.9 million) for development activities. Our 2001 development expenditures related principally to the development of fields including Suizhong 36-1 (Phase II), Qinhuangdao 32-6, Wenchang 13-1/13-2 and Dongfang 1-1.

Financing

We had net cash inflows from financing of RMB7,472.6 million (US\$902.9 million) in 2001. Our net cash inflows resulted primarily from the our proceeds of RMB10,101.6 million (US\$1,220.5 million) received from our initial public offering and short term loans of RMB2,500 million (US\$302.1 million). We had cash outflows of RMB3,497.5 million (US\$422.6 million) for repayment of bank loans, and cash outflows of RMB1,657.0 million (US\$200.2 million) for retirement fund payments to our parent company.

At the end of 2001, our debt to capital ratio was 11.9%. The following table summarizes the maturities of our long-term debt outstanding as of December 31, 2001:

Maturity Date	RMB (in millions)
2002	1,231.8
2003	794.6
2004	462.6
2005	483.4
After 2005	1,515.1
Total	4,487.5

Market Risks

Our primary market risk exposures are fluctuations in oil and gas prices, exchange rates and interest rates.

Commodity price risk: we are exposed to fluctuations in prices of crude oil and natural gas, which are commodities whose prices are determined by reference to international market prices. International oil and gas prices are volatile and this volatility has a significant effect on our net sales and net income. We do not hedge market risk resulting from fluctuations in oil and gas prices.

Foreign exchange risk: our sales revenues are mainly denominated in RMB and US Dollars. Due to the current stable RMB exchange rate policy and ample foreign exchange reserves held by the PRC government, we believe that there is no significant risk of a substantial RMB depreciation. Furthermore, our oil and gas prices are quoted in US Dollars based on international oil and gas prices, which can help us offset the foreign exchange risk of US Dollar capital expenditures. As a result, we believe that we are not actually exposed to the exchange risk between the RMB and the US Dollar. Our exposure to foreign exchange risk arises primarily from our yen-denominated debt.

By the end of 2001, foreign currency liabilities accounted for 83.6% of our total debts. Yen-denominated debt of JPY27,709.7 million and US Dollar-denominated debt of US\$242.3 million account for 38.9% and 44.7% of the total debt respectively. We have consistently and dynamically managed our yen liability in accordance with the principle of "just

hedge, no speculation". Since April 2000, 94% of the yen liability is under exposure to foreign exchange risk. Our only existing currency swap was entered into in 1995 in relation to a yen loan we had taken up at the beginning of the same year. The swap locks in a rate of 95 JPY/USD compared to the drawing rate of 83.6 JPY/USD on the yen loan. In 2001, the Company gained US\$28.4 million which shows our management of our yen liability is basically successful.

Interest rate risk: at the beginning of 2001, our foreign currency denominated floating interest rate debt and fixed interest rate debt were US\$215.7 million and US\$387.9 million respectively, which dropped to US\$142.3 million and US\$310.9 million at the end of 2001 and accounted for 31.4% and 68.6% respectively of our total foreign currency denominated debt. Of the foreign currency fixed interest rate debt, 67.8% is denominated in yen. The remaining 32.2% is denominated in US dollars.

Our cost of floating interest rate debt decreased by approximately 60% as a result of last year's 11 interest rate cuts by the US Federal Reserve. According to the payment schedules, our floating interest rate foreign currency debt will be repaid in the next one and a half years and, as a result, we believe that we will not be exposed to the risk of large interest rate increases. We did not swap any fixed rate debt to floating rate because the interest on such debt had been capitalized, and the average cost of capital of only 5.66% can be entirely supported by our oil and gas development project.

Management Discussion and Analysis (Cont'd)

At the end of 2001, our RMB debt was RMB736.3 million, consisting of 91% floating interest rate debt and 9% fixed interest rate debt, accounting for 16.4% of our total debt. At present, any RMB derivative business is prohibited in the PRC. February 2002 saw the eighth downward adjustment in exceeding 5 year RMB loan interest rate of 0.45% and as a result, we expect to save some interest expenses.

We will continue to adhere to the principle of prudent debt risk management. We will manage the foreign exchange and interest rate risk of debt dynamically according to market movements. We will select financial institutions with good credit as transaction counter parties, thereby doing our best to minimize risk.

Significant Investments

In 2001, we started acquisition of the Xihu Trough located in the East China Sea and prepaid US\$45.0 million for the acquisition. The working interests to be acquired included not only the existing natural gas reserves in the Xihu Trough but also the rights to explore and develop the area. The ODP report for the Xihu Trough has not been completed yet. As such, in accordance with United States Securities and Exchange Commission rules, the reserves have not been booked as the Company's reserves.

Material Acquisitions and Disposals of Subsidiaries and Associated Companies

We have not made any material acquisitions and disposals of subsidiaries and associated companies in the course of the financial year ended December 31, 2001.

Employee Benefits

We had slightly over 1,000 employees at the end of 2001. With a view to ensuring that our compensation packages are competitive in the industry and our employees are motivated to perform well in their jobs, we have adopted a flexible and efficient human resources policy.

We have adopted two stock option schemes for our senior management since February 4, 2001. In 2001, four units and 44 employees were granted the Chairman's Special Awards for outstanding performance. In 2001, we have improved our human resources management system by establishing through the Internet an employee performance evaluation system and a recruitment system. We focused on customised and effective training for our employees and conducted 325 training courses in various areas in 2001 which were attended by more than 7,000 people.