## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In reviewing the following discussion, please also refer to the Company's consolidated financial statements and their notes contained in this interim report.

**Overview**

For the six months ended June 30, 2002, profit before taxation of the Group was RMB29,532 million, representing a decrease of 26.17% compared with the corresponding period last year. Net profit was RMB19,579 million, representing a decrease of 27.93% compared with the corresponding period last year. The decrease in profitability was due primarily to general decreases in prices of crude oil, refined products and chemical products. Profits were primarily derived from the sale of crude oil from the Group's exploration and production segment.

Basic and diluted earnings per share of the Company for the six months ended June 30, 2002 was RMB0.11.

**Six Months Ended June 30, 2002 Compared To Six Months Ended June 30, 2001**

**Consolidated Operating Results**

Turnover  Turnover decreased 11.66% from RMB122,169 million for the six months ended June 30, 2001 to RMB107,928 million for the six months ended June 30, 2002. This was due primarily to the significant decrease in the selling prices of the Group's crude oil and refined products.

Operating Expenses  Operating expenses decreased 5.11% from RMB80,671 million for the six months ended June 30, 2001 to RMB76,549 million for the six months ended June 30, 2002. This was due primarily to the decreased expenses in purchases, services and other expenses and selling, general and administrative expenses.

Purchases, Services and Other Expenses  Purchases, services and other expenses decreased 12.43% from RMB35,129 million for the six months ended June 30, 2001 to RMB30,762 million for the six months ended June 30, 2002. This mainly reflects the decreased purchase expenses for refining operations resulting from lower crude oil prices and the decreased chemicals purchase expenses resulting from the decreased raw chemical material prices.

Employee Compensation Costs  Employee compensation costs increased 6.68% from RMB6,328 million for the six months ended June 30, 2001 to RMB6,751 million for the six months ended June 30, 2002.  The increase was due primarily to the fact that after the selling enterprises of the Group suffered selling losses last year, which led to decreases in the employee compensation costs, the selling enterprises of the Group recorded selling profits this year, which led to relative increases in the employee compensation costs as a result of the relative increases in employee compensation and increases of bonuses for cost reduction and for exceeding the production targets set for the exploration and production segment.

Selling, General and Administrative Expenses  Selling, general and administrative expenses decreased 5.49% from RMB10,334 million for the six months ended June 30, 2001 to RMB9,767 million for the six months ended June 30, 2002.  This decrease was due primarily to the lower selling, general and administrative expenses resulting from decreases in losses relating to bad debts.

Depreciation, Depletion and Amortisation  Depreciation, depletion and amortisation increased 3.75% from RMB18,195 million for the six months ended June 30, 2001 to RMB18,877 million for the six months ended June 30, 2002. This increase was due primarily to the Group's disposal of some of the installations of the refining and marketing segment and the chemicals and marketing segment, and to the increase in current depreciation, depletion and amortisation expenses resulting from the increase in the newly added plant and equipment.

Taxes Other than Income Taxes  Taxes other than income taxes decreased 3.98% from RMB7,390 million for the six months ended June 30, 2001 to RMB7,096 million for the six months ended June 30, 2002. This decrease was due primarily to decreased sales revenue from crude oil and refined products and the resulting decreases in the urban construction tax and the surcharges for education.

Profit From Operations  Profit from operations decreased 24.38% from RMB41,498 million for the six months ended June 30, 2001 to RMB31,379 million for the six months ended June 30, 2002.

Net Exchange Gain (Loss)  Net exchange gain (loss) decreased from a net gain of RMB287 million for the six months ended June 30, 2001 to a net loss of RMB239 million for the six months ended June 30, 2002.  This decrease was due primarily to the significant increase in foreign exchange rates, such as British Sterling and Euro, in the first half of 2002, resulting in increased foreign exchange losses in respect of foreign currency borrowings.

Net Interest Expense  Net interest expense decreased 18.04% from RMB2,090 million for the six months ended June 30, 2001 to RMB1,713 million for the six months ended June 30, 2002. This decrease was due primarily to a decrease in the average balance of debts and decreases in the average borrowing interest rates in the first half of 2002.

Profit Before Taxation  Profit before taxation decreased 26.17% from RMB39,998 million for the six months ended June 30, 2001 to RMB29,532 million for the six months ended June 30, 2002.

Taxation  Taxation decreased 24.76% from RMB13,160 million for the six months ended June 30, 2001 to RMB9,902 million for the six months ended June 30, 2002 due primarily to a decrease in profit before taxation.

Net Profit  Net profit decreased 27.93% from RMB27,168 million for the six months ended June 30, 2001 to RMB19,579 million for the six months ended June 30, 2002.

**Segment Information**

**The Group is engaged in a broad range of petroleum and related activities through its four major business segments: the Exploration and Production Segment, the Refining and Marketing Segment, the Chemicals and Marketing Segment, and the Natural Gas and Pipeline Segment.**

**Exploration and Production**

**The exploration and production segment is engaged in the exploration, development, production and sale of crude oil and natural gas.**

Turnover  Turnover decreased 15.37% from RMB78,849 million as at June 30, 2001 to RMB66,732 million as at June 30, 2002. This decrease was due primarily to a significant decline in the average realised selling price of our crude oil. As the Company's oil prices are directly linked to the international oil prices, declines in the international oil prices have therefore caused a decrease of 18.42% in the Company's average realised selling price of crude oil, from US$24.65 per barrel as at June 30, 2001 to US$20.11 per barrel as at June 30, 2002.

Intersegment sales decreased 16.97% from RMB58,393 million as at June 30, 2001 to

RMB48,486 million as at June 30, 2002. This decrease was due primarily to a decrease in the price of crude oil sold to the other business segments.

Operating Expenses Operating expenses increased 0.42% from RMB36,951 million as at June 30, 2001 to RMB37,107 million as at June 30, 2002 due primarily to an increase in various expenses resulting from an increased production volume in the first half of 2002 compared to the same period last year.

Profit From Operations Profit from operations decreased 29.29% from RMB41,898 million as at June 30, 2001 to RMB29,625 million as at June 30, 2002.

**Refining and Marketing**

**The refining and marketing segment is engaged in the refining, transportation, storage and marketing of crude oil and petroleum products.**

Turnover Turnover decreased 12.46% from RMB86,380 million as at June 30, 2001 to RMB75,620 million as at June 30, 2002. This decrease was due primarily to the fact that the prices in the domestic refined products market were directly linked to the prices in the international refined products market. The significant decrease in the prices of crude oil and refined products in the international market resulted in decreases in the prices of gasoline, diesel oil and kerosene.

Sales revenue from gasoline decreased 13.63% from RMB23,992 million as at June 30, 2001 to RMB20,723 million as at June 30, 2002. This decrease was due primarily to a significant decrease in the price of gasoline. The average realised selling price of gasoline decreased 15.80%, from RMB2,721 per ton as at June 30, 2001 to RMB2,291 per ton as at June 30, 2002.

Sales revenue from diesel decreased 7.76% from RMB36,889 million as at June 30, 2001 to RMB34,027 million as at June 30, 2002. This decrease was due primarily to a significant decrease in the price of diesel. The average realised selling price of diesel decreased 10.67%, from RMB2,419 per ton as at June 30, 2001 to RMB2,161 per ton as at June 30, 2002.

Sales revenue from kerosene decreased 18.36% from RMB2,217 million as at June 30, 2001 to RMB1,810 million as at June 30, 2002. This decrease was due primarily to a decrease in the price of kerosene. The average realised selling price of kerosene decreased 20.18% from RMB2,344 per ton as at June 30, 2001 to RMB1,871 per ton as at June 30, 2002.

Intersegment sales revenue decreased 7.94% from RMB4,346 million as at June 30, 2001 to RMB4,001 million as at June 30, 2002. This decrease was due primarily to a significant decrease in the price of refined products.

Operating Expenses Operating expenses decreased 14.07% from RMB85,799 million as at June 30, 2001 to RMB73,723 million as at June 30, 2002. This decrease was due primarily to a decrease in the costs of crude oil purchased as a result of a decrease in the price of crude oil.

Profit From Operations Profit from operations increased 226.51% from RMB581 million as at June 30, 2001 to RMB1,897 million as at June 30, 2002.

**Chemicals and Marketing**

**The chemicals and marketing segment is engaged in the production and sale of basic petrochemical products, derivative petrochemical products, and other chemical products.**

Turnover Turnover decreased 16.07% from RMB15,913 million as at June 30, 2001 to RMB13,355 million as at June 30, 2002. This decrease was due primarily to overall decreases in the prices of principal chemical products in the first half of this year compared to the same period in

2001 as a result of a decrease in the prices of chemical products in the first half of this year. The decrease in turnover was also due to a decrease in the output and hence the sales volume of chemical products as a result of the repair and maintenance of some of the Group's installations.

Operating Expenses Operating expenses decreased 16.19% from RMB16,732 million as at June 30, 2001 to RMB14,023 million as at June 30, 2002. This decrease resulted primarily from decreases in purchases, services and other expenses due to decreases in the prices of raw materials. Operating expenses also decreased due to lower selling and administrative expenses as a result of decreased losses related to bad debts.

Profit (Loss) From Operations The loss from operations decreased from RMB819 million as at June 30, 2001 to RMB668 million as at June 30, 2002.

**Natural Gas and Pipeline**

**The natural gas and pipeline segment is engaged in the transmission of natural gas and crude oil, and the sale of natural gas.**

Turnover Turnover increased 17.71% from RMB5,391 million as at June 30, 2001 to RMB6,346 million as at June 30, 2002. This increase was due primarily to an increase in the selling prices of the natural gas segment and an increase in the sales volume. The sales volume of natural gas increased 10.77% from 219.1 billion cubic feet as at June 30, 2001 to 242.7 billion cubic feet as at June 30, 2002.

Operating Expenses Operating expenses increased 5.89% from RMB5,230 million as at June 30, 2001 to RMB5,538 million as at June 30, 2002. This increase was due primarily to an increase in the costs of natural gas purchased resulting from an increase in the sales volume of natural gas.

Profit From Operations Profit from operations increased 401.86% from RMB161 million as at June 30, 2001 to RMB808 million as at June 30, 2002.

**Liquidity and Capital Resources**

As at June 30, 2002, the Group's primary sources of funding were cash provided by operating activities, short-term and long-term borrowings, and cash and cash equivalents. The Group's funds were primarily used for capital expenditures, repayment of short-term and long-term borrowings, and distributions of dividends to shareholders.

As at June 30, 2002, short-term debt comprised 4.59% of our capital employed as compared with 4.70% as at June 30, 2001. Our ability to obtain adequate financing to satisfy our capital expenditures and debt servicing requirements may be limited by our financial condition and the results of operations, and by the liquidity of international and domestic capital markets. In addition, prior to accessing international capital markets, we must obtain approvals from various PRC government authorities. In general, we must obtain PRC government approvals for any project involving significant capital investment of our refining and marketing, and chemicals and natural gas segments.

We plan to fund the capital and related investments principally through the cash provided by operating activities, short-term and long-term debt, and cash and cash equivalents. Net cash provided by operating activities for the six months ended June 30, 2002 was RMB35,092 million. As at June 30, 2002, we had cash and cash equivalents of RMB13,211 million. Cash and cash equivalents were primarily denominated in Renminbi (Renminbi accounting for approximately 91.15% and United States Dollar accounting for approximately 8.85%).

The Board of Directors believes that our working capital is sufficient to satisfy the present requirements for our investments and operations.

The table below sets forth our cash flows for each of the six months ended June 30, 2001 and 2002 and our cash and cash equivalents at the end of each period:

| | Six months ended June 30, 2002 (RMB million) | Six months ended June 30, 2001 (RMB million) |
|---|---|---|
| Net cash provided by operating activities | 35,092 | 41,405 |
| Net cash used for investing activities | (20,790) | (24,973) |
| Net cash used for financing activities | (12,208) | (19,251) |
| Cash and cash equivalents at the end of each period | 13,211 | 15,241 |

**Cash Provided by Operating Activities**

Our net cash provided by operating activities decreased from RMB41,405 million as at June 30, 2001 to RMB35,092 million as at June 30, 2002. This decrease was due primarily to decreases in turnover and profit from operations.

As at December 31, 2001, we had a working capital deficit of RMB2,336 million. As at June 30, 2002, we had a working capital surplus of RMB9,948 million. This surplus was due primarily to the fact that we continued to repay a portion of our short-term liabilities with internally generated cash flow, thereby turning the Company's working capital deficit into surplus.

**Cash Provided by (Used for) Financing Activities**

Our net borrowings as at June 30, 2002 and December 31, 2001 were as follows:

| | June 30, 2002 (RMB million) | December 31, 2001 (RMB million) |
|---|---|---|
| **Short-term debt (including current portion of long-term debt)** | 18,074 | 23,111 |
| **Long-term debt** | 67,072 | 65,484 |
| **Total debt** | 85,146 | 88,595 |
| Less: | | |
| Cash and cash equivalents | 13,211 | 11,117 |
| Time deposits with term exceeding three months | 2,638 | 3,253 |
| Receivables under resale agreements | 6,943 | 11,505 |
| Net debt | 62,354 | 62,720 |

The maturity profile of long-term debts of the Group is as follows:

| | Principal as at June 30, 2002 (RMB million) |
|---|---|
| To be repaid within one year | 4,996 |
| To be repaid within one to two years | 16,388 |
| To be repaid within two to five years | 34,453 |
| To be repaid after five years | 16,231 |
| | 72,068 |

Of the total debts of the Group as at June 30, 2002, approximately 36.17% were fixed-rate loans and 63.83% were floating-rate loans. Of the total debts as at June 30, 2002, approximately

76.91% were denominated in Renminbi, approximately 19.44% were denominated in United States Dollar, approximately 1.60% were denominated in British Sterling, approximately 1.07% were denominated in Japanese Yen and approximately 0.98% were denominated in Euro.

As at December 31, 2001 and June 30, 2002, the amount of short-term debts owed to the related parties were RMB1,268 million and RMB353 million, respectively. As at December 31, 2001 and June 30, 2002, the amount of long-term debts owed to the related parties were RMB20,753 million and RMB23,994 million, respectively.

As at June 30, 2002, our debts included short-term and long-term debts owed to China Petroleum Finance Company Limited of RMB353 million and RMB23,994 million, respectively.

Our net cash used for financing activities as at June 30, 2002 showed a decrease of 36.59% compared with the six months ended June 30, 2001. This decrease was primarily resulted from the following:

- a decrease in the repayment of short-term loans leading to a decrease of RMB10,946 million in cash outflow;
- a decrease in the repayment of long-term loans leading to a decrease of RMB634 million in cash outflow;
- a decrease in the distribution of dividends leading to a decrease of RMB5,634 million in cash outflow.

Such decrease in cash outflow was offset by the following:

- a decrease in new short-term loans leading to a decrease of RMB118 million in cash inflow;
- a decrease in new long-term loans leading to a decrease of RMB9,726 million in cash inflow.

As at June 30, 2002, RMB230 million worth of the Group's loans (RMB284 million as at December 31, 2001) were secured loans (financing lease and bank loans). RMB56 million worth of bank loans (RMB58 million as at December 31, 2001) were secured by plant and equipment of the Group in the amount of RMB55 million (RMB111 million as at December 31, 2001). Given that title to the leased property will be transferred to the lessor in the event of default, debts incurred by way of financing lease are in fact secured debts. As at June 30, 2002, the debts incurred by the Group by way of financing lease amounted to RMB174 million (RMB226 million as at December 31, 2001). The net book value of the properties, plant and equipment under financing lease was RMB496 million (RMB428 million as at December 31, 2001).

The debt to capitalisation ratio (debt to capitalisation ratio = interest-bearing debts/(interest-bearing debts + shareholder's equity)) as at June 30, 2002 was 21.89% (23.21% as at December 31, 2001).

## Capital Expenditures

The table below sets forth our capital expenditures by business segment for each of the six months ended June 30, 2001 and the six months ended June 30, 2002. Capital expenditures increased 20.38% from RMB18,727 million as at June 30, 2001 to RMB22,543 million as at June 30, 2002. The increase was due primarily to the commencement of work on the West-East gas pipeline project and an increase of capital expenditures as a result of the Company' development of overseas oil exploration and development business.

| | For the six months ended June 30, | | | | | |
|---|---|---|---|---|---|---|
| | 2002 | | 2001 | | 2002 (estimated value) | |
| | (RMB million) | % | (RMB million) | % | (RMB million) | % |
| Exploration and roduction | 16,303* | 72.3 | 13,265* | 70.8 | 38,637 | 62.5 |
| Refining and marketing | 2,691 | 11.9 | 4,035 | 21.5 | 11,251 | 18.2 |
| Chemicals and marketing | 790 | 3.5 | 590 | 3.2 | 4,090 | 6.6 |
| Natural gas and pipeline | 2,645 | 11.8 | 685 | 3.7 | 7,392 | 11.9 |
| Other | 114 | 0.5 | 152 | 0.8 | 513 | 0.8 |
| Total | 22,543 | 100.0 | 18,727 | 100.0 | 61,883 | 100.0 |

*Note**: If the investments relating to geological and geophysical exploration costs were included, the capital expenditures for the exploration and production segment for the first half of 2002, the first half of 2001 and the estimated value for the entire year of 2002 would be RMB18,025 million, RMB14,969 million and RMB42,654 million, respectively.

**Exploration and Production**

The majority of our capital expenditures and investments relates to the exploration and production segment. Capital expenditures on exploration and production for the six months ended June 30, 2002 totalled RMB16,303 million, including RMB3,213 million for exploration activities and RMB13,064 million for development activities. Capital expenditures for the six months ended June 30, 2001 totalled RMB13,265 million, including RMB3,159 million for exploration activities and RMB8,728 million for development activities. The increase in our capital expenditures from the six months ended June 30, 2001 to the six months ended June 30, 2002 was due primarily to an increase in capital investments as a result of our development of overseas oil exploration and development business and the implementation of our development projects ahead of schedule as compared to last year.

We anticipate that capital expenditures for our exploration and production segment for the year ending December 31, 2002 will amount to RMB38,637 million, and capital expenditures and investments will amount to RMB42,654 million. Approximately RMB6,337 million of the capital expenditures is expected to be used for oil and gas exploration activities and approximately RMB32,300 million for oil and gas development activities. We plan to focus our exploration efforts on the Tarim basin for natural gas and on the Erdos, Junggar and Songliao basins for oil.

**Refining and Marketing**

Capital expenditures for our refining and marketing segment for the six months ended June 30, 2002 was RMB2,691 million, of which RMB1,329 million was spent on the expansion of the retail marketing network of our refined products and storage infrastructure facilities, and RMB998 million was spent on the renovation of our refining facilities. Total capital expenditures for the six months ended June 30, 2001 were RMB4,035 million. The decrease in capital expenditures from the six months ended June 30, 2001 to the six months ended June 30, 2002 was due primarily to a decrease in the percentage of the retail marketing network of the refined products acquired for the segment and an increase in the percentage of newly-constructed projects, with the majority of the investments in the newly-constructed projects being completed in the second half of 2002.

We anticipate that capital expenditures and investments for our refining and marketing segment for the year ending December 31, 2002 will amount to RMB11,251 million, which include approximately RMB4,951 million for investments in our refined product retail marketing network in order to add more service stations and storage facilities, and approximately RMB6,300 million for the construction and expansion of refining facilities.

**Chemicals and Marketing**

Capital expenditures for our chemicals and marketing segment for the six months ended June 30, 2002 increased from RMB590 million for the six months ended June 30, 2001 to RMB790 million for the six months ended June 30, 2002. The increase in capital expenditures was due primarily to the fact that better preparations were made this year for the projects in this segment and works were able to commence ahead of schedule, causing an increase in capital expenditures in the first half of this year compared to the same period last year.

We anticipate that capital expenditures and investments for our chemicals and marketing segment for the year ending December 31, 2002 will amount to RMB4,090 million, which include the capital expenditures and investments for the expansion of capacity and upgrading of ethylene production facilities at Daqing petrochemical plant.

**Natural Gas and Pipeline**

Capital expenditures in our natural gas and pipeline segment for the six months ended June 30, 2002 totalled RMB2,645 million, of which RMB1,921 million was spent on the West-East gas pipeline project and RMB701 million was spent on the upgrading of existing pipelines and the construction of new pipelines. Capital expenditures for the six months ended June 30, 2001 totalled RMB685 million. The increase in our capital expenditures from the six months ended June 30, 2001 to the six months ended June 30, 2002 was due primarily to the commencement of the West-East gas pipeline project.

We anticipate that capital expenditures and investments for our natural gas and pipeline segment for the year ending December 31, 2002 will amount to RMB7,392 million. Approximately RMB6,051 million is expected to be invested in the West-East gas pipeline project and the Zhong-Wu and Lan-Cheng-Yu natural gas pipeline. We currently expect that approximately RMB508 million will be invested in the natural gas storage infrastructure projects and other natural gas pipeline and approximately RMB833 million will be used for investments in the transmission pipelines for crude oil and refined product.

**Other**

Our non segment-specific capital expenditures for the six months ended June 30, 2001 and the six months ended June 30, 2002 were RMB152 million and RMB114 million, respectively. Our non segment-specific capital expenditures related primarily to the non segment-specific equipment purchases and research and development activities.

We anticipate that the Group's non segment-specific capital expenditures and investments for the year ending December 31, 2002 will amount to RMB513 million, which will be primarily used for the construction of water and electricity supply systems, and roads and telecommunications systems to be used by various segments.

**Material Investments**

On July 4, 2002, the Company signed a Joint Venture Framework Agreement ("JVFA") in Beijing with a group of international energy companies (the "International Consortium") in respect of the West-East gas pipeline project (the "Project"), and the commencement of full construction of the Project.

The International Consortium comprises six international energy companies and is led by

Shell International Gas Limited ("Shell"), OAO Gazprom ("Gazprom") and ExxonMobil China Gas Pipeline Limited ("ExxonMobil"), which hold equal interests in the Project. This is a group of strong partners for the Company for the development, construction and operation of the Project.

The signing of the JVFA marks a significant achievement in the Company's partner selection process for the Project. The Company, the International Consortium and China Petroleum & Chemical Corporation will have interests in the Project of 50%, 45% and 5%, respectively. The Project will have a cooperation term of 45 years.

The completion and operation of the Project will result in the rapid growth of the Company's natural gas sales through the development of substantial natural gas reserves in the Tarim basin. The Project is expected to increase the Company's profitability in the coming years and generate attractive returns for the Company. In addition, the Project will further strengthen the Company's position in the natural gas market in China.

The Company's expected total equity investment in the upstream projects and the Pipeline Contractual Joint Venture is approximately RMB22.6 billion (equivalent to approximately HK$21.3 billion). The Company expects the pipeline and the upstream projects to earn respective returns of 12% and above 15% after tax in real terms (not considering debt financings).

The Board of Directors believes that the Project is strategically important to the Company in terms of enhancing the Company's value, economic efficiency and competitiveness.

**Material Acquisition or Disposal**

The Group has no material acquisition or disposal for the six months ended June 30, 2002.

**Foreign Exchange Rate Risk**

We conduct our business primarily in Renminbi. However, a portion of our Renminbi revenue is converted into other currencies to meet foreign currency financial instrument obligations and to pay for imported equipment and materials.

The Renminbi is not a freely convertible currency. Limitations on foreign exchange transactions imposed by the PRC government could cause future exchange rates to vary significantly from current or historical exchange rates. The fluctuations in Renminbi exchange rates will affect our ability to perform our foreign exchange denominated obligations. Such fluctuations will also affect our ability to pay dividends in Hong Kong Dollars or to pay dividends in respect of American depositary receipts in United States Dollars. We believe that the Company is or will be able to obtain sufficient foreign exchange for the performance of such obligations. To date, we do not hedge against currency risks through the use of financial contracts or other agreements.

## Employees

### Number of Employees

As at June 30, 2001 and June 30, 2002, we had 430,226 and 421,012 employees, respectively. The table below sets forth the number of our employees by business segment as at June 30, 2002:

| | Number of Employees | % of total |
|---|---|---|
| Exploration and production | 232,784 | 55.29 |
| Refining and marketing | 114,753 | 27.26 |
| Chemicals and marketing | 60,465 | 14.36 |
| Natural gas and pipeline | 10,278 | 2.44 |
| Other* | 2,732 | 0.65 |
| Total | 421,012 | 100.00 |

*Note**: Including research and development, planning and headquarters management.

### Employee Compensation

The total employee compensation payable by the Company for the six months ended June 30, 2002 was RMB3,893 million, being the total monthly salaries of our employees during the report period. Compensation of our employees is determined according to industry practice and the actual conditions of the Company, and is based on the principles of attracting and retaining the high-calibre personnel, and motivating all staff for the realisation of the best results.

Our senior management compensation system links senior management members' financial interests (including those of our executive directors and our supervisors) with the Group's operating results and the market performance of our shares. We have entered into performance contracts with our senior management. Under this system, the senior management members' compensation has three components, namely, fixed salaries, performance bonuses and share options. The variable components in their compensation account for approximately 70% to 75% of our senior management officers' total potential compensation, including approximately 15% to 25% forming the performance bonus component and approximately 50% to 60% forming the share options component. Variable compensation rewards are linked to the attainment of specific performance targets, such as net income, return on capital and cost reduction targets. The table below sets forth the components of the total potential compensation for key officers:

| | % Fixed salary | % Share options | % Performance bonus |
|---|---|---|---|
| Chairman | 30 | 70 | 0 |
| President | 25 | 60 | 15 |
| Vice President | 25 | 60 | 15 |
| Department GM | 25 | 50 | 25 |

Details of the directors' and supervisors' emoluments for the six months ended June 30, 2001 and the six months ended June 30, 2002 are as follows:

| | Six months ended June 30, | |
|---|---|---|
| | **2002** | **2001** |
| | **(RMB'000)** | **(RMB'000)** |
| Fee for directors and supervisors | 50 | 87 |
| Salaries, allowances and other benefits | 346 | 498 |
| Contribution to retirement benefit scheme | 13 | 11 |
| | 409 | 596 |

The number of directors and supervisors whose emoluments fall within the following bands:

| | Six months ended June 30 | |
|---|---|---|
| | **2002** | **2001** |
| | **Number** | **Number** |
| Nil - RMB1,000,000 | 12 | 12 |

Upon exercise of their share options, members of the senior management will not receive any shares in the Company, but will, by way of stock appreciation rights, receive a monetary sum which is calculated on the basis of the share price of the H shares listed on the HKSE.

**Workforce Reduction Plan**

The Company has no new plan to further reduce its workforce in the next few years, but will continue to adjust the composition and to raise the qualifications of its staff, having regard to the progress of the shut-down of production installations of low efficiency or suffering loss, with the view of creating a sound employment mechanism which enables the recruitment and dismissal of employees as and when required.

**Training Programmes**

In order to enhance the Company's competitiveness and to prepare the Company for the new challenges after China's accession to the WTO so that it will be able to cope well with the keen competition in the international market in the future and in order for the Company to become a transnational company able to compete with other international players, the Company has, from this year onwards, adopted a "143 Training Programme" for the training of high-calibre personnel. Under this programme, 100 enterprise operation and management officers (entrepreneurs), 400 senior technical personnel and 300 senior professionals will receive training over a period of approximately five years. They will, for example, study degree courses at reputable overseas universities, receive on-job training and conduct research on particular topics in training institutions and relevant companies. This team of high-calibre personnel is expected to enable the Company to compete in the international market.

## CONTINGENT LIABILITIES

Information on the Group's contingent liabilities as of June 30, 2002 is as follows:

**Bank and other guarantees**

As at June 30, 2002, the Group had contingent liabilities in respect of bank and other guarantees and other matters arising in the ordinary course of business from which it is anticipated that no material liabilities will arise.

**Environmental liabilities**

CNPC and the Group have operated in China for many years and certain environmental problems have developed. China has adopted extensive environmental laws and regulations that affect the operation of the oil and gas industry. The outcome of environmental liabilities under proposed or future environmental legislation cannot reasonably be estimated at present, but could be material. Under the existing legislation, however, the management believes that there are no probable environmental liabilities, in addition to amounts which have already been reflected in the financial statements, that will have a materially adverse effect on the financial position of the Group.

**Legal contingencies**

The Group is the named defendant in certain insignificant lawsuits as well as the named party in certain other proceedings arising in the ordinary course of business. While the outcomes of such contingencies, lawsuits or other proceedings cannot be determined at present, the management believes that any resulting liabilities will not have a materially adverse effect on the financial position of the Group.

**Leasing of roads, land and buildings**

According to the Restructuring Agreement entered into between the Company and CNPC, CNPC has undertaken to the Company the following: CNPC will use its best endeavours to obtain formal land use right certificates to replace the entitlement certificates in relation to the 28,649 parcels of land which were leased or transferred to the Company from CNPC, within one year from August, September and October 1999 when the relevant entitlement certificates were issued; CNPC will complete, within one year from November 5, 1999, the necessary governmental procedures for the requisition of the collectively-owned land on which 116 service stations owned by the Company are located; and CNPC will obtain individual building ownership certificates in the name of the Company for all of the 57,482 buildings transferred to the Company by CNPC, before November 5, 2000.

As at June 30, 2002, CNPC has obtained the formal land use right certificates for 12,417 of the 28,649 parcels of land mentioned above and some of the individual building ownership certificates for the above-mentioned buildings, but has not completed the necessary governmental procedures for the above-mentioned collectively-owned land on which the service stations are located . The Directors of the Company confirm that the use of and the conduct of relevant activities at the above-mentioned parcels of land, service stations and buildings are not affected by the fact that the relevant land use right certificates or individual building ownership certificates have not been obtained or the fact that the relevant governmental procedures have not been completed. In management’s opinion, the outcome of the above events will not have a materially adverse effect on the results of operations or the financial position of the Group.

**Group insurance**

Except for limited insurance coverage for vehicles and certain assets subject to significant operating risks, the Group does not carry any other insurance for property, facilities or equipment with respect to its business operations. In addition, the Group does not carry any third-party liability insurance against claims relating to personal injury, property and environmental damages or business interruption insurance since such insurance coverage is not customary in China. While the effect of under-insurance cannot be reasonably estimated at present, management believes it could have a material impact on the operating results or financial position of the Group.

**Cost reduction measures**

In addition to workforce reduction and shut-down of certain manufacturing facilities, the

Company is currently evaluating options to further streamline production facilities and implement other cost reduction measures within the next several years to further improve the operating efficiency and competitiveness of the Group.  Management has not approved all significant actions to be taken to complete such plan. Management does not believe it will have a material adverse impact on the Group's fnancial position, but it could have a material adverse effect on the Group's rsults of operations.