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 annual report.

Overview

For the twelve months ended December 31, 2002, profit before taxation of the Group was RMB69,240 million, representing an increase of 1.63% compared with the corresponding period in the previous year. Net profit was RMB46,910 million, representing an increase of 3.17% compared with the corresponding period in the previous year. The increase in the Group's profitability was primarily attributed to the increase in the sales volume of crude oil, major refined products and natural gas, the rise in the price of natural gas and the increase in the gross profit from the sale of refining and natural gas. 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 twelve months ended December 31, 2002 were RMB0.27.

Twelve Months Ended December 31, 2002 Compared With Twelve Months Ended December 31, 2001

Consolidated Operating Results

· **Turnover**

Turnover increased 1.29% from RMB241,320 million for the twelve months ended December 31, 2001 to RMB244,424 million for the twelve months ended December 31, 2002. This increase was due primarily to the increases in sales volume of products such as crude oil, natural gas, gasoline and diesel and the rise in the comprehensive selling price of natural gas.

· **Operating Expenses**

Operating expenses increased 1.12% from RMB170,181 million for the twelve months ended December 31, 2001 to RMB172,083 million for the twelve months ended December 31, 2002. This increase was due primarily to the increases in exploration expenses, expenses for shutting down of manufacturing assets, employee compensation costs and depreciation, depletion and amortisation, which, however, was offset in part by the decrease in purchases, services and other expenses and the decrease in various costs resulting from enhancement of management.

· **Purchases, Services and Other Expenses**

Purchases, services and other expenses decreased 8.71% from RMB78,529 million for the twelve months ended December 31, 2001 to RMB71,690 million for the twelve months ended December 31, 2002. This decrease was due primarily to the decrease in the cost of refined products raw materials as a result of a decline in the price of crude oil and the decrease in the cost for purchase of chemicals raw materials as a result of a decline in the price of chemicals raw materials.

· **Employee Compensation Costs**

Employee compensation costs increased 11.23% from RMB14,608 million for the twelve months ended December 31, 2001 to RMB16,248 million for the twelve months ended December 31, 2002. This increase was due primarily to the increase in bonuses for cost reduction and for exceeding the production targets set for the exploration and production segment and the increase in the employee compensation costs as a result of increased labour costs for the expansion of the selling and retailing network for the refining and marketing segment.

· **Depreciation, Depletion and Amortisation**

Depreciation, depletion and amortisation increased 9.42% from RMB33,615 million for the twelve months ended December 31, 2001 to RMB36,782 million for the twelve months ended December 31, 2002. This increase was due primarily to the increase in current depreciation, depletion and amortisation expenses resulting from the newly added asset as investment completed and impairment provision for the chemicals and marketing segment and the refining and marketing segment.

· **Selling, General and Administrative Expenses**

Selling, general and administrative expenses increased 3.40% from RMB21,735 million for the twelve months ended December 31, 2001 to RMB22,474 million for the twelve months ended December 31, 2002. The increase was due primarily to the higher transportation costs resulting from an increased sales volume in refined products and to the increased selling, general and administrative expenses resulting from increases in maintenance expenses resulting from the Group in upgrading its service stations.

· **Employee Separation Costs and Shut Down of Manufacturing Assets**

Employee separation costs and the costs for shutting down of manufacturing assets for the twelve months ended December 31, 2001, comprised only the employee separation costs of RMB487 million. The Company did not lay off any employee in the twelve months ended December 31, 2002 but did shut down some installations of the refining and marketing segment and the chemicals and marketing segment, thereby employee separation costs and the costs for shutting down of manufacturing assets, comprised only the costs for shutting down of manufacturing assets of RMB2,121 million.

· **Taxes Other than Income Taxes**

Taxes other than income taxes increased 4.75% from RMB13,951 million for the twelve months ended December 31, 2001 to RMB14,613 million for the twelve months ended December 31, 2002. This increase was due primarily to an increase in consumption tax resulting from an increased sales volume of gasoline and diesel and to an increase in urban construction and education surcharges as a result of increases in VAT and consumption tax.

· **Profit From Operations**

Profit from operations increased 1.69% from RMB71,139 million for the twelve months ended December 31, 2001 to RMB72,341 million for the twelve months ended December 31, 2002.

· **Net Exchange Gain/(Loss)**

Net exchange gain/loss decreased from a net gain of RMB250 million for the twelve months ended December 31, 2001 to a net loss of RMB316 million for the twelve months ended December 31, 2002. This decrease was due primarily to the increase in exchange rate loss for borrowings in foreign currencies as a result of a relatively huge appreciation of foreign exchange rates, such as for Japanese Yen, British Sterling and Euro.

· **Net Interest Expense**

Net interest expense decreased 15.17% from RMB3,599 million for the twelve months ended December 31, 2001 to RMB3,053 million for the twelve months ended December 31, 2002. This decrease was due primarily to the decline of market interest rate as well as the decrease in the average balance of debts.

· **Profit Before Taxation**

Profit before taxation increased 1.63% from RMB68,131 million for the twelve months ended December 31, 2001 to RMB69,240 million for the twelve months ended December 31, 2002.

· **Taxation**

Taxation decreased 3.62% from RMB23,066 million for the twelve months ended December 31, 2001 to RMB22,231 million for the twelve months ended December 31, 2002. This decrease was due primarily to the tax reductions enjoyed by the Group under the preferential tax treatment policy promulgated by the State in order to encourage development of western China's economy which, however, was offset in part by the increase in expenses other than tax deductible expenses and the tax settlement for previous years.

· **Net Profit**

Net profit increased 3.17% from RMB45,469 million for the twelve months ended December 31, 2001 to RMB46,910 million for the twelve months ended December 31, 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 0.65% from RMB148,277 million for the twelve months ended December 31, 2001 to RMB147,308 million for the twelve months ended December 31, 2002. This decrease was due primarily to a direct linkage between the Company's crude oil prices and the international oil prices and the effect of delay of the prices of domestic crude oil in reflecting the international market. The average realised selling price of the Company’s crude oil decreased 4.79% from US$23.61 per barrel for the year 2001 to US$22.48 per barrel for the year 2002. The decrease in the average realised selling price was offset in part by the increase in sales revenue resulting from the inclusion into this segment of the small refineries in Tarim, Changqing and Xinan oil/gas fields.

Intersegment sales decreased 4.04% from RMB110,738 million for the twelve months ended December 31, 2001 to RMB106,266 million for the twelve months ended December 31, 2002. This decrease was due primarily to a decline in the price and the sales volume in which crude oil was sold to other business segments.

· **Operating Expenses**

Operating expenses increased 5.36% from RMB71,345 million for the twelve months ended December 31, 2001 to RMB75,169 million for the twelve months ended December 31, 2002. This increase was due primarily to an increase in purchases, services and other expenses and in exploration expenses as a result of the inclusion of the small refineries in Tarim, Changqing and Xinan oil/gas fields into this segment for administrative convenience in 2002 and to an increase in the employee compensation costs as a result of increase in bonuses for cost reduction and for exceeding the production targets.

· **Profit From Operations**

Profit from operations decreased 6.23% from RMB76,932 million for the twelve months ended December 31, 2001 to RMB72,139 million for the twelve months ended December 31, 2002.

Refining and Marketing

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

· **Turnover**

Turnover increased 1.55% from RMB171,961 million for the twelve months ended December 31, 2001 to RMB174,621 million for the twelve months ended December 31, 2002. This increase was due primarily to an increase in the sales volume of principal refined products such as gasoline, diesel and lubricant oil.

Sales revenue from gasoline increased 3.73% from RMB47,079 million for the twelve months ended December 31, 2001 to RMB48,834 million for the twelve months ended December 31, 2002. This increase was due primarily to an increase of 4.57% in the sales volume of gasoline from 18.17 million tons for the twelve months ended December 31, 2001 to 19.00 million tons for the twelve months ended December 31, 2002. The average realised selling price of gasoline decreased 0.81% from RMB2,591 per ton for the twelve months ended December 31, 2001 to RMB2,570 per ton for the twelve months ended December 31, 2002.

Sales revenue from diesel increased 3.33% from RMB76,534 million for the twelve months ended December 31, 2001 to RMB79,081 million for the twelve months ended December 31, 2002. This increase was due primarily to an increase of 5.13% in the sales volume of diesel from 31.55 million tons for the twelve months ended December 31, 2001 to 33.17 million tons for the twelve months ended December 31, 2002. The average realised selling price of diesel decreased 1.73%, from RMB2,426 per ton in the twelve months ended December 31, 2001 to RMB2,384 per ton for the twelve months ended December 31, 2002.

Sales revenue from kerosene decreased 12.64% from RMB4,423 million for the twelve months ended December 31, 2001 to RMB3,864 million for the twelve months ended December 31, 2002. This decrease was due primarily to a decrease of 2.59% in sales volume of kerosene from 1.93 million tons for the twelve months ended December 31, 2001 to 1.88 million tons for the twelve months ended December 31, 2002. The average realised selling price of kerosene decreased 10.48%, from RMB2,290 per ton in the twelve months ended December 31, 2001 to RMB2,050 per ton for the twelve months ended December 31, 2002.

Intersegment sales revenue increased 18.40% from RMB8,436 million for the twelve months ended December 31, 2001 to RMB9,988 million for the twelve months ended December 31, 2002. This increase was due primarily to an increase in the sales volume of naphtha and liquefied gas to other segments.

· **Operating Expenses**

Operating expenses decreased 1.99% from RMB175,285 million for the twelve months ended December 31, 2001 to RMB171,803 million for the twelve months ended December 31, 2002. This decrease was due primarily to the decline of purchase prices for raw materials, decrease in processing volume as a result of exclusion of the small refineries in Tarim, Changqing and Xinan oil/gas fields from this segment for administrative convenience in this year and the decline of processing loss and maintenance expenses arising from management improvement in respect of production, operations and equipment management, actively carrying forward of technical renovation and implementation of energy-saving measures for installations.

· **Profit/(Loss) From Operations**

Profit/(Loss) from operations increased from a loss of RMB3,324 million for the twelve months ended December 31, 2001 to a gain of RMB2,818 million for the twelve months ended December 31, 2002.

Chemicals and Marketing

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

· **Turnover**

Turnover decreased 6.66% from RMB31,776 million for the twelve months ended December 31, 2001 to RMB29,661 million for the twelve months ended December 31, 2002. This decrease was due primarily to a decrease in the sales volume of chemical products.

· **Operating Expenses**

Operating expenses decreased 3.89% from RMB34,150 million for the twelve months ended December 31, 2001 to RMB32,823 million for the twelve months ended December 31, 2002. This decrease was due primarily to a decrease in purchases, services and other expenses as a result of the decrease in sales volume and the fact that the segment gave first priority to making key enterprises profitable, enhanced management, tapped potentials and improved efficiency, and strictly controlled and reduced various expenses and due to a decrease in selling and administrative expenses as a result of reasons such as decrease in the provision for impairment of receivables compared to last year.

· **Profit/(Loss) From Operations**

Profit/(Loss) from operations increased from a loss of RMB2,374 million for the twelve months ended December 31, 2001 to a loss of RMB3,162 million for the twelve months ended December 31, 2002.

Natural Gas and Pipeline

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

· **Turnover**

Turnover increased 12.47% from RMB11,321 million for the twelve months ended December 31, 2001 to RMB12,733 million for the twelve months ended December 31, 2002. This increase was due primarily to an increase in the national price of natural gas and an increase in the comprehensive selling price and the sales volume of the Group's natural gas as a result of the Group's effort in optimising the gas selling structure.

· **Operating Expenses**

Operating expenses increased 5.49% from RMB10,599 million for the twelve months ended December 31, 2001 to RMB11,181 million for the twelve months ended December 31, 2002. This increase was due primarily to an increase in the costs for purchasing natural gas resulting from an increase in the sales volume of natural gas.

· **Profit From Operations**

Profit from operations increased 114.96% from RMB722 million for the twelve months ended December 31, 2001 to RMB1,552 million for the twelve months ended December 31, 2002.

Liquidity and Capital Resources

As at December 31, 2002, the Group's primary sources of funding were cash generated from 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 December 31, 2002, short-term borrowings comprised approximately 5.12% of our available capital as compared with approximately 6.55% as at December 31, 2001. Our ability to obtain adequate financing to satisfy our capital expenditures and debt repayment requirements may be limited by our financial condition and the results of operations, and by the liquidity of the international and domestic capital markets. In addition, prior to accessing the 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 relating to our refining and marketing, chemicals and marketing, and natural gas and pipeline segments.

We plan to fund capital and related investments primarily with the cash generated from operating activities, short-term and long-term borrowings, and cash and cash equivalents. Net cash generated from operating activities for the twelve months ended December 31, 2002 was RMB98,341 million. As at December 31, 2002, we had cash and cash equivalents of RMB9,977 million. Cash and cash equivalents were primarily denominated in Renminbi.

In the opinion of the management, our working capital is sufficient for meeting the present requirements for our investments and operations.

The table below sets forth our cash flows for each of the twelve months ended December 31, 2001 and 2002 and our cash equivalents at the end of each period.

	As at December 31,	
	2002	2001
	RMB million	RMB million
Net cash from operating activities	98,341	84,439
Net cash used for investing activities	(71,662)	(61,491)
Net cash used for financing activities	(27,829)	(29,906)

Cash and cash equivalents at the end of year	9,977	11,127

Cash Generated by Operating Activities

Our net cash generated by our operating activities increased from RMB84,439 million for the twelve months ended December 31, 2001 to RMB98,341 million for the twelve months ended December 31, 2002. This increase was due primarily to the increase in the turnover and operating profit of the Company and a significant amount of cash inflow to working capital resulting from a shortened collection period of receivables imposed by the Company.

As at December 31, 2001, we had a working capital deficit of RMB6,950 million. As at December 31, 2002, we had a working capital deficit of RMB14,189 million. This deficit was due primarily to the reduction rate of the Company's current assets being higher than the reduction rate of the Company's current liabilities. As the Company increased its effort in the collection and handling of receivables, the accounts receivables and other receivables were reduced, thereby reducing our current assets. The reduction of current liabilities was due primarily to our continuous effort in strengthening the centralised management of funds and debts and to reduce the current liabilities by repaying parts of short-term borrowings with the cash flow generated by operating activities of the Company.

Cash Provided by (or Used for) Financing Activities

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

	As at December 31,	
	2002	2001
	RMB million	RMB million
Short-term borrowings (including current portion of long-term borrowings)	20,633	25,323
Long-term borrowings	60,655	65,546
Total borrowings	81,288	90,869
Less:		
Cash and cash equivalents	9,977	11,127
Time deposits with maturities over three months	2,612	3,253
Receivables under resale agreements	9,786	11,505
Net debt	58,913	64,984

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

	Principal as at December 31, 2002
	RMB million

To be repaid within one year	6,209
To be repaid within one to two years	19,580
To be repaid within two to five years	31,974
To be repaid after five years	9,101
	66,864

Of the total debts of the Group as at December 31, 2002, approximately 29.59% were fixed-rate loans and 70.41% were floating-rate loans. Of the total debts as at December 31, 2002, approximately 80.96% were denominated in Renminbi, approximately 15.96% were denominated in United States Dollar, approximately 1.63% were denominated in British Sterling, approximately 0.89% were denominated in Japanese Yen and approximately 0.56% were denominated in Euro.

As at December 31, 2001 and December 31, 2002, the amount of short-term borrowings owed to related parties were RMB1,268 million and RMB570 million, respectively. As at December 31, 2001 and December 31, 2002, the amount of long-term borrowings owed to related parties were RMB20,753 million and RMB24,132 million, respectively.

As at December 31, 2002, the major part of our debts owed to the related parties includes short-term and long-term borrowings owed to China Petroleum Finance Company Limited, which are RMB570 million and RMB24,132 million, respectively.

Our net cash used for financing activities for the twelve months ended December 31, 2002 showed a decrease of 6.95% compared with the twelve months ended December 31, 2001. This decrease primarily resulted from the following:

· an increase in new short-term loans leading to an increase of RMB3,779 million in cash inflow;

· a decrease in the repayment of short-term loans leading to a decrease of RMB1,852 million in cash outflow;

· a decrease in the distribution of dividends leading to a decrease of RMB9,049 million in cash outflow;

Such decrease was offset by the following:

· an increase in the repayment of long-term loans leading to an increase of RMB252 million in cash outflow;

a decrease in new long-term loans leading to a decrease of RMB11,370 million in cash inflow;

a sum of RMB430 million paid in 2002 for acquisition of refined products sales enterprises of the CNPC Group (no such outflow in 2001) leading to an increase of RMB430 million in cash outflow.

As at December 31, 2002, RMB398 million worth of loans made to the Group (RMB1,357 million in 2001) were secured loans (finance lease and bank loans), of which RMB276 million worth of the bank loans (RMB1,131 million in 2001) were secured by plants and equipment of the Group worth RMB426 million (RMB1,024 million in 2001). Given that title to the leased property will be transferred to the lessor in the event of default, debts incurred by way of finance lease are in fact secured debts. As at December 31, 2002, the debts incurred by the Group by way of finance lease amounted to RMB122 million (RMB226 million in 2001). The net book value of the properties, plants and equipment under finance lease was RMB399 million (RMB428 million in 2001).

The debt to equity ratio (debt to equity ratio = interest-bearing debts/(interest-bearing debts + shareholder's equity)) as at December 31, 2002 was 20.43% (23.82% as at

December 31, 2001).

Capital Expenditures

The table below sets forth our capital expenditures by business segments for each of the twelve months ended December 31, 2001 and December 31, 2002. Capital expenditures increased 19.78% from RMB61,549 million for the twelve months ended December 31, 2001 to RMB73,726 million for the twelve months ended December 31, 2002. The increase was due primarily to an increase of RMB7,985 million in capital expenditure of the Company for the West-East Gas Pipeline Project (the "Project"), the construction of which has fully commenced, an increase of RMB1,952 million in capital expenditure for expanding the Company's overseas oil exploration and development business and an increase in capital expenditure for investment in domestic exploration of oil and gas.

	As at December 31,					
	2002年		2001年		2003(estimated alue)	
	RMB million	%	RMB million	%	RMB million	%
Exploration and production*	46,078*	62.5	41,193*	66.9	44,280*	57.4
Refining and marketing	11,327	15.4	11,416	18.5	9,463	12.3
Chemicals and marketing	3,175	4.3	4,062	6.6	5,737	7.4
Natural gas and pipeline	13,013	17.6	4,557	7.5	17,000	22.1
Others	133	0.2	321	0.5	600	0.8
Total	73,726	100.0	61,549	100.0	77,080	100.0

*Note:If the investments relating to geological and geophysical exploration costs were included, the capital expenditures and investments for the exploration and production segment for the years 2001 and 2002 and the estimated capital expenditures and investments for 2003 would be RMB45,115 million, RMB50,646 million and RMB49,100 million, respectively.

Exploration and Production

The majority of our capital expenditures and investments relates to the exploration and production segment. Capital expenditures for exploration and production segment for the twelve months ended December 31, 2002 totalled RMB46,078 million, including RMB6,136 million for exploration activities and RMB35,558 million for development activities. Capital expenditures for the twelve months ended December 31, 2001 totalled RMB41,193 million, including RMB6,239 million for exploration activities and RMB29,444 million for development activities. The increase in our capital expenditures from the twelve months ended December 31, 2001 to the twelve months ended December 31, 2002 was due primarily to increases in capital expenditures for expanding the Group's overseas exploration and development business and for upstream development projects in relation to the Project and increases in expenses for development activities resulting from an appropriate increase in the crude oil production capacity under high oil price.

We anticipate that for the year ending December 31, 2003, capital expenditures and investments will be RMB49,100 million for the exploration and production segment of the Group, of which RMB44,280 million will be capital expenditures. Approximately RMB7,609 million of the capital expenditures is expected to be used for exploration activities for oil and gas and approximately RMB34,371 million for development activities for oil and gas. We plan to focus our gas exploration in Tarim Basin and our oil exploration in Ordos Basin, Junggar Basin and Songliao Basin.

Refining and Marketing

Capital expenditures for our refining and marketing segment for the twelve months ended December 31, 2002 totalled RMB11,327 million, of which RMB5,652 million was spent on the expansion of our refined products retail marketing network and storage infrastructure facilities, and RMB5,675 million was spent on the renovation of our refining facilities. Total capital expenditures for the twelve months ended December 31, 2001 were RMB11,416 million. The capital expenditures for refining and marketing segment for the twelve months ended December 31, 2002 were basically maintained at the same level as the capital expenditures for refining and marketing segment for the twelve months ended December 31, 2001.

We anticipate that capital expenditures and investments for our refining and marketing segment for the year ended December 31, 2003 will amount to RMB9,463 million, which include:

· approximately RMB4,800 million for the construction and expansion of refining facilities;

· approximately RMB4,663 million for investments in our refined products sales network in order to add more service stations and storage facilities.

Chemicals and Marketing

Capital expenditures for our chemicals and marketing segment for the twelve months ended December 31, 2002 decreased 21.84% from RMB4,062 million for the twelve months ended December 31, 2001 to RMB3,175 million for the twelve months ended December 31, 2002. The decrease in capital expenditures was due primarily to our insistence on making prudent investment and our adoption of a more rigorous return-based evaluation system, leading to a stricter control over and a decrease in capital expenditures for the chemicals and marketing segment.

We anticipate that capital expenditures and investments for the chemicals and marketing segment of the Group for the year ending December 31, 2003 will amount to RMB5,737 million, which include the expenditures for expanding the capacity and transforming the Daqing petrochemical ethylene installations.

Natural Gas and Pipeline

Capital expenditures for our natural gas and pipeline segment for the twelve months ended December 31, 2002 totalled RMB13,013 million, of which RMB12,115 million was spent on the construction of long distance pipeline including RMB9,239 million spent on the Project. Capital expenditures for the twelve months ended December 31, 2001 totalled RMB4,557 million. The increase in our capital expenditures was due primarily to an increase in capital expenditures for the Project, the construction of which had been fully commenced and welding work of the principal part of the Jingbian-Shanghai pipeline section had been substantially completed.

We anticipate that capital expenditures and investments for our natural gas and pipeline segment for the year ended December 31, 2003 will amount to RMB17,000 million, of which approximately RMB14,000 million is expected to be invested in the Project and RMB1,600 million for the Zhong-Wu and the second Shaanxi-Beijing natural gas pipelines, approximately RMB900 million to be invested in the natural gas storage infrastructure projects and other natural gas pipeline and approximately RMB500 million to be invested in the pipeline for the transmission of crude oil and refined products.

Others

Our non-segment-specific capital expenditures for the twelve months ended December 31, 2001 and December 31, 2002 were RMB321 million and RMB133 million, respectively. Our non-segment-specific capital expenditures related primarily to 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, 2003 will amount to RMB600 million, which will be used primarily for the construction work of various segments for their mutual benefits.

Material Investment

On July 4, 2002, the Company signed a Joint Venture Framework Agreement in Beijing with a group of international energy companies (the "International Consortium") and the construction of the Project has fully commenced.

The International Consortium comprises of six international energy companies including Shell International Gas Limited ("Shell"), OAO Gazprom ("Gazprom") and ExxonMobil China Gas Pipeline Limited ("ExxonMobil"), which are partners for the Company for the development, construction and operation of the Project. Shell, Gazprom and ExxonMobil lead the International Consortium and will hold equal interest in the Project.

The Company, the International Consortium and China Petroleum & Chemical Corporation ("Sinopec") will hold 50%, 45% and 5% interests in the Project 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 the 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.

It is expected that a total amount of RMB27.3 billion will be required for investing in the development and production of natural gas fields for the purpose of providing gas to the West-East gas pipelines for 45 years. The Company and the International Consortium will be responsible for financing the development and production of natural gas fields based on their respective interests in each of the upstream projects. It is anticipated that the Pipeline Contractual Joint Venture will require a total investment of approximately RMB43.5 billion, 35% of which will be provided by the Company, Sinopec and the International Consortium in the form of equity capital in proportion to their respective interests in the Pipeline Contractual Joint Venture, and 65% of which will be provided by way of debt financing. The Company's equity investment in pipeline co-operation is estimated at approximately RMB7.6 billion. At present, the total amount of investment in the Sales Contractual Joint Venture has not yet been determined, but is expected to be fairly limited.

The Company's expected total equity investment in the upstream projects and the Pipeline Contractual Joint Venture is approximately RMB22.6 billion. The Company expects the pipeline and the upstream projects to earn respective returns of 12% and about 15% after tax in real terms.

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.

Major Acquisition or Disposal

The Group did not have any major acquisition or disposal in the year ended December 31, 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.

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, even though the PRC government is currently implementing a stable foreign exchange policy and holds a tremendous amount of foreign exchange reserves. The fluctuations in Renminbi exchange rates will affect our ability to perform our foreign exchange obligations. Such fluctuations will also affect our ability to pay dividends in Hong Kong Dollar or to pay dividends in respect of American Depositary Shares in United States Dollar. We believe that the Company is or will be able to obtain sufficient foreign exchange for the performance of such obligations. We do not hedge against currency risks through the use of financial contracts or other agreements.

Crude Oil and Natural Gas Price Risk

The business operation of the Company is affected by the price fluctuation of crude oil and natural gas. The Company determines the benchmark price of crude oil monthly based on the crude oil price in Singapore market. The PRC government promulgates the retail medium guidance prices for gasoline and diesel in the PRC market based on the offshore trading prices of gasoline and diesel in Singapore, Rotterdam and New York markets in the previous period. In 2002, the retail medium guidance prices for gasoline and diesel in the PRC market were adjusted four times.

Historically, prices of crude oil and refined products in international market fluctuated tremendously due to changes in many factors such as global and regional development of economic and political environments (e.g. suspension of supply arising from war or terrorism, effect on demand for crude oil and refined products resulted from growth or shrinkage of the global economy), and global and regional demand and supply of crude oil and refined products. It is and will still be very difficult for the Company to control the factors affecting the international crude oil and refined products prices. The Company anticipates that international crude oil and refined products prices will remain unstable and uncertain. Decline of crude oil price will affect business activities, operation results, financial conditions as well as the value of proved reserves of the Company.

Industrial Risk

Like other crude oil and natural gas companies in the PRC, the business activities of the Company are subject to regulation and control of the PRC government in many aspects such as grant of exploration and production licence, special tax to be imposed relating to the industry and environmental and safety standard, which may affect the business operation of the Company. As such, the Company may be subject to a substantial restriction when implementing its business strategy, when developing and expanding its business or when maximising its profitability. Any future change in the PRC government's policy on crude oil and natural gas industry may also affect the business operation of the Company.

Employees

- **Number of Employees**

As at December 31, 2001 and December 31, 2002, we had 422,554 and 419,598 employees respectively. The table below sets forth the number of our employees by business segment as at December 31, 2002:

	Number of Employees	% of total
Exploration and production	233,885	55.74
Refining and marketing	113,355	27.02
Chemicals and marketing	59,292	14.13
Natural gas and pipeline	10,332	2.46
Other*	2,734	0.65
Total	419,598	100.00

*Note:Including employees of exploration research and development centre, planning centre, headquarters and professional management.

- **Remuneration**

The total remuneration payable by the Company for the twelve months ended December 31, 2002 was RMB10,631 million, being the total monthly salaries of our employees during the reporting period. Compensation of our employees is determined according to industry practice and the actual conditions of the Company, and based on the principles of attracting and retaining the best people and motivating all staff for the realisation of the best results.

Our senior management remuneration system links senior management members' financial interests (including those of our executive directors and our supervisors) with the Company's operating results and the market performance of our shares. Our senior management members have entered into performance contracts with us. Under this system, the senior management members' compensation has three components, namely, fixed salaries, performance bonuses and stock appreciation rights. The variable components in their compensation account for approximately 70% to 75% of our senior management officers' total potential compensation, including approximately 0% to 25% forming the performance bonus component and approximately 50% to 70% forming the stock appreciation rights component. Variable compensation rewards are linked to the attainment of specific performance targets, such as net profit, and return on capital and cost reduction targets. The chart below sets forth the components of the total potential compensation for key officers.

	Basic salary (%)	Stock appreciation rights (%)	Performance bonus (%)
Chairman	30	70	0
President	25	60	15
Vice President	25	60	15
Department General Manager	25	50	25

Details of the directors' and supervisors' emoluments for the twelve months ended December 31, 2001 and the twelve months ended December 31, 2002 are as follows:

	For the twelve months ended December 31	
	2002	2001
	RMB thousand	RMB thousand
Fess for directors and supervisors	128	170
Salaries,allowances and other benefits	1,042	1,104
Contribution to retirement benefit scheme	25	23
	1,195	1,297

The numbers of directors and supervisors whose fees fall within the following band:

	For the twelve months ended December 31	
	2002	2001
	Number of Persons	Number of Persons
Nil-RMB1,000,000	13	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.

- **Employee Separation Plan**

During the period from 1999 to 2002, a total of 58.3 thousand people were laid off, which has met the target of laying off 50,000 employees committed originally by the Company.

The Company has no new plan to further reduce its workforce in large number in the next few years, but may reduce its workforce in small number, taking into consideration the progress of the shut-down of production installations of low efficiency or those which are suffering loss.

- **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 entrepreneural 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, conduct research on particular topics and receive on-the-job training at reputable overseas universities, training institutions and relevant companies. This team of high-calibre personnel is expected to enable the Company to increase its competiveness in the international market.

· **Basic Medical Insurance for Employees**

Since October 1, 2002, the Company has implemented basic medical insurance measures for employees (the "Measures") and other companies within the Group have also generally adopted such Measures.

According to the Measures, the employer will make contributions to the basic medical insurance premium at 6% to 10% of the employees' salaries. As the implementation of the Measures is subject to local policies, the implementation dates vary and there are certain differences among the specific regulations issued by various cities on the basic medical insurance for employees.

As the difference between the amount to be paid by the Company in relation to basic medical insurance premium and that under the original payment terms for employees medical expenses is not substantial, there was little effect on the Company's financial position and no material effect on either the consolidated profit and loss account or the consolidated balance sheet.

Contingent Liabilities

Information on the Group's contingent liabilities as of December 31, 2002 is as follows:

· **Bank and Other Guarantees**

As at December 31, 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**

The PRC 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 be estimated at present, and could be material. Under the existing legislation, however, the management of the Group believes that there are no probable environmental liabilities, except those amounts which have already been reflected in the financial statements, that will have a material 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 material 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 the

CNPC Group, the CNPC Group has undertaken to the Company the following: the CNPC Group 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 the CNPC Group, within one year from August, September and October 1999 when the relevant entitlement certificates were issued; the CNPC Group will complete, within one year of 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 the CNPC Group will obtain individual building ownership certificates in the name of the Company for all of the 57,482 buildings transferred to the Company by the CNPC Group, before November 5, 2000.

As at December 31, 2002, the CNPC Group has obtained formal land use right certificates in relation to 22,670 out of the 28,649 above-mentioned parcels of land and some building ownership certificates, but has completed none of the necessary governmental procedures for the collectively-owned land on which the service stations are located. The directors of the Company believe 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, and that these will not have material 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 the PRC. While the effect of such under-insurance on future incidents cannot be reasonably assessed at present, the Group's management believes that it could have a material impact on the operating results in the future, but would not have material adverse impact on the financial position of the Group.

· **Cost Reduction Measures**

The Company may further streamline production and operation facilities within the next several years to further improve the operating efficiency and competitiveness of the Company. The management has not approved all significant actions to be taken to complete such measures. The management does not believe that it will have material adverse impact on the Group's financial position, but it could have material adverse effect on the Group's results of operations.

Integration of A Shares

The Company entered into a share transfer agreement and share custody agreement with Xi'an Feitian Science, Industrial and Trading Group Company Limited ("Xi'an Feitian") and Wuhan Luzhou Enterprise (Group) Company Limited ("Wuhan Luzhou") on May 23, 2002. The share transfer agreement provides that the Company shall transfer 27% and 8.90% of the state-owned legal person shares in Petroleum Long Champ (Group) Co., Ltd. ("Long Champ") to Xi'an Feitian and Wuhan Luzhou respectively. The share transfer agreement was approved by the Ministry of Finance of the PRC on December 31, 2002. The Company ceased to have any interest in Long Champ after the share transfer.

The Company entered into a share transfer agreement with China Electronic Information Industrial Group Company ("China Electronic") on July 12, 2002. The share transfer agreement provides that the Company shall transfer 51.60% of the state-owned legal person shares in Gansu Tristar Petrochemical (Group) Co., Ltd. ("Tristar") to China Electronic. On July 25, 2002, the Ministry of Finance granted its approval to the transfer of the state-owned legal person shares in Tristar. A waiver from acquisition of all stock shares was granted by the China Securities Regulatory Commission in respect of the share transfer on December 30, 2002. The Company ceased to have any interest in Tristar after the share transfer.

The entire proceeds from the transfer of shares in Long Champ and Tristar are used for the production and operations of the core business of the Company.

Acquisition of service stations

The Company and the CNPC Group signed an agreement on September 26, 2002 whereby the Company has acquired from the CNPC Group all the assets and liabilities of 686 unlisted sales enterprises. The assets acquired mainly comprise of 2,994 service stations, 478 storage facilities, 5,337 pieces of land (with a total area of 53.38 million square metres) and some office buildings that are located in more than 500 counties in 15 provinces or autonomous regions of the PRC.

The Directors of the Company are of the opinion that such unlisted sales enterprises have shared more than 80% of their local market in respect of refined products, more than 60% of their local retail market and own the resources including associated service stations, storage facilities and stable clients which provide the Company with an important platform for expansion of the sales and distribution network and development of the retail distribution.

The Directors of the Company are of the opinion that the operating loss continuously suffered by unlisted sales enterprises in the past two years was due primarily to the lack of funds, the decrease in sales and the existence of too many redundant employees, which had driven up the cost. The profitability of the acquired assets can be remarkably improved and better prospects for profits can be achieved through continued restructuring. It is anticipated that the expansion of the retail proportion will lead to an increase in gross profit and in the total sales revenue of the Company. The acquisitions will further improve the Company’s sales and distribution network, increase its control over the market and its overall resistance against market risks.