

BUSINESS OPERATING REVIEW

The Company was established as a joint stock limited company with limited liability under the laws of the PRC on November 5, 1999 as part of the restructuring of the CNPC Group. In the restructuring, the CNPC Group, the parent company of the Company, injected into the Company most of the assets, liabilities and interests of the CNPC Group relating to its domestic exploration and production, refining and marketing, chemical products and natural gas businesses. The ADSs and H shares of the Company were listed on the NYSE and the HKSE on April 6, 2000 and April 7, 2000 respectively.

The Company is engaged in a broad range of petroleum-related activities, including:

- the exploration, development, production and sale of crude oil and natural gas;
- the refining, transportation, storage and marketing of crude oil and petroleum products;
- the production and sale of basic petrochemical products, derivative chemical products and other chemical products; and
- the transmission of natural gas and crude oil and sale of natural gas.

The Company is the largest producer of crude oil and natural gas in the PRC and one of the largest companies in the PRC in terms of sales.

Market Review

Crude Oil Market Review

International crude oil prices skyrocketed in 2002, increasing by US\$16 per barrel, or as much as 87%, within one year. The annual average price for WTI, Brent and Minas crude oils in 2002 was US\$26.19 per barrel, US\$25.08 per barrel and US\$25.72 per barrel respectively, representing a respective increase of US\$0.34 per barrel, US\$0.63 per barrel and US\$1.65 per barrel over their annual average price in 2001. In response to the impact from international oil prices, domestic crude oil prices had increased significantly. However, the annual average prices for domestic crude oil remained lower than the 2001 level due to the lagged effects in the linkage of domestic crude oil prices to the international crude oil prices.

Crude oil imports continued to increase in 2002, rising by 15% over the previous year to a total of 69.41 million tons. In 2002, the domestic output of crude oil and crude oil process volume reached 168 million tons and 206 million tons respectively.

Refined Products Market Review

In general, the domestic market for refined products in 2002 achieved a steady increase in prices and consumption, a rough balance between supply and demand, a more reasonable commercial inventory and a healthy and orderly development of the market.

The prices of the domestic gasoline and diesel markets lagged behind the changes in international crude oil prices. Under the influence of both foreign and domestic factors, the price in the domestic market in 2002 fluctuated and the retail medium guidance prices for gasoline and diesel showed an increase, but the annual average reference retail medium guidance prices for both gasoline and diesel were lower than the 2001 level.

The national consumption of refined products was 122 million tons in 2002, and the demand and supply were balanced for most part of the year. However, a disparity began to emerge in the second half of the year between the variety of refined products supplied and the variety of refined products consumed. The most notable difference between supply and demand lies in that of gasoline which was slightly undersupplied, and that of diesel

which had an oversupply. The national inventory of refined products declined from approximately 11 million tons at the beginning of 2002 to approximately 8.5 million tons at the end of that year.

In addition, due to the adoption by the State of a series of measures to put the distribution of refined products into order, the distribution of refined products has become more orderly. As a result of the continued integration in domestic retail of refined products, the community and regional private service stations were steadily replaced by major suppliers as the dominant distributors on the market.

Chemical Products Market Review

The global economy was gradually adjusted in 2002. Accordingly, the chemicals market saw a fluctuated but rising trend for prices, but the average prices of principal products remained slightly lower than those of 2001.

At the beginning of 2002, the global resources inventory was at a relatively low level. Economic recovery led to an increase in domestic demand for chemical products. There was a relatively large increase in imports as well as an increase in production capacity compared to the previous year. As a result, the supply and demand for the entire chemical products were more or less at a balance.

With the lowering of customs duties by the PRC in 2002, countries neighbouring Asia fixed their eyes more and more on the PRC market. In particular, the large-scale, low-cost ethylene production project newly constructed in the Middle East was also targeted at the PRC market. As a result, the competition in the domestic chemicals market of the PRC intensified, leading to a decline in the prices of domestic chemical products.

Company Business Review

Exploration and Production

As at December 31, 2002, the Company had proved reserves of approximately 10.94 billion barrels of crude oil and approximately 38,800 billion cubic feet of natural gas. For the twelve months ended December 31, 2002, the Company's annual total output of oil and gas amounted to 870.64 million barrels, including 769.81 million barrels of crude oil and 605.0 billion cubic feet of marketable natural gas, representing an average production of 2.109 million barrels of crude oil and 1.658 billion cubic feet of marketable natural gas per day. The Company sold 735 million barrels of crude oil and 588.4 billion cubic feet of natural gas. Approximately 73% of the crude oil sold by the Company was purchased by the refineries of the Company. For the twelve months ended December 31, 2002, the Company successfully reduced its lifting cost to US\$4.32 per barrel from US\$5.05 per barrel at the time of listing, which is basically close to that of other companies in the industry worldwide. The difference from the target of US\$4.15 per barrel committed at the time of listing is due primarily to an increase in the Company's output of crude oil resulting from an increase of the price of crude oil compared with that at the time of listing, which in turn resulted in a relatively high cost for such additional output, which, however, still brought a relatively good return to the Company.

Refining and Marketing

For the twelve months ended December 31, 2002, the Company's refineries processed 569 million barrels of crude oil, or an average of 1.5589 million barrels per day. Approximately 94% of the crude oil processed in the Company's refineries was supplied by the exploration and production segment. The Company produced approximately 47.65 million tons of gasoline, diesel and kerosene and sold approximately 54.05 million tons of these products. The Company is actively expanding its sales and distribution networks, in

particular the retail distribution network, by capitalising fully on the complementary value-added effect resulting from the integration of refining and marketing. As at December 31, 2002, there were 13,160 service stations either owned, controlled or franchised by the Company or owned by CNPC but to which the Company provides supervisory support. As at December 31, 2002, the Company owned and operated a crude oil pipeline network of approximately 9,215 kilometres and a refined products pipeline of 2,276 kilometres. The processing costs of the refining unit of the Company are also declining steadily, from RMB138 per ton to RMB136 per ton. By the end of 2002, the refining and marketing segment successfully achieved the cost reduction target committed by the Company at the time of listing.

In 2002, the Company completed the "catalyst project" in Dalian Petroleum Corporation (which processed 3.5 million tons of oil), marking the completion of supporting facilities for the oil refinery bases with a capacity of 10 million tons or more and the presence of a strong foundation for future centralised refinery work.

The Company acquired from the CNPC Group, in September 2002, its interest in 686 unlisted enterprises in the PRC, with the unlisted enterprises holding the ownership of 2,994 service stations. Details are set out in the section headed "Management's Discussion and Analysis of Financial Condition and Results of Operations"- "Acquisition of Service Stations".

Chemicals and Marketing

For the twelve months ended December 31, 2002, the Company produced 1.582 million tons of ethylene, 1.965 million tons of synthetic resin, 0.267 million tons of synthetic fibres, 0.214 million tons of synthetic rubber and 3.411 million tons of urea. Up to December 31, 2002, the chemicals and marketing segment successfully achieved the cost reduction target committed by the Company at the time of listing.

Natural Gas and Pipeline

The natural gas and pipeline segment is the Company's core business segment for further development. For the twelve months ended December 31, 2002, the Company produced 605.0 billion cubic feet of marketable natural gas, of which 486.3 billion cubic feet was sold through the natural gas and pipeline segment. The Company currently owns and operates 13,391 kilometres of regional natural gas pipeline networks, of which 12,299 kilometres are operated by the natural gas and pipeline segment.

After the Se-Ning-Lan Pipeline was completed and put into operation, the capacity of natural gas transmission has been increased. The State Development Planning Commission's approval on the feasibility study in relation to the Zhong-Wu Pipeline was obtained in November 2002 and part of the control engineering work for this pipeline project has been commenced. The Company has also commenced the preparatory work for construction of the pipelines, which can be commenced in full scale immediately after obtaining the approval from the State Development Planning Commission. The Cang-Zi Pipeline was completed and put into operation in March 2002. The Lan-Cheng-Yu Pipeline for refined products has been completed and put into operation in November 2002 and has been in smooth operation since then. The construction of the West-East Gas Pipeline Project commenced in July 2002 and has been advancing smoothly. The major engineering work for its eastern section has basically been completed and the Yellow River has been tunnelled through at Yanshuiguan. The completion of the Se-Ning-Lan Pipeline, the Zhong-Wu Pipeline, the Cang-Zi Pipeline, the Lan-Cheng-Yu Pipeline and the West-East Gas Pipeline will serve as a strong and solid foundation for the further development of the natural gas and pipeline segment.

Details of the West-East Gas Pipeline Project are set out in the section headed "Management's Discussion and Analysis of Financial Condition and Results of Operations" - "Material Investments".

Overseas Business Development

In 2002, the Company achieved breakthrough development in respect of its overseas business and conducted research and assessment of more than 20 overseas project opportunities. In 2002, the Company acquired all the share capital in Devon Energy Indonesia Ltd., a company in Indonesia engaged in exploration and production of crude oil and natural gas, and as a result acquired interests of 4.27 million barrels of oil equivalent.