Management Discussion and Analysis

Outlook

The global economy has finally bottomed out in 2003 and is on the way to recovery. We expect that the pick up will be strengthened in 2004 and the global economy will return to a positive trajectory. However, fragility exists in developed economies and the risk of terrorist attacks in the world are both reasons for our prudent expectations for global economic development in 2004. Although the international oil price remained strong in 2003, the trend is dependent on the fundamentals of the global economy. Political and economic events will definitely impact the oil price, resulting in adverse effects on the Company's development. The Company primarily operates in countries in Asia Pacific, such as China and Indonesia. The political stability and economic dynamism within China, where most of the Company's operations are, will provide the necessary opportunities for the Company to gear up its development. Meanwhile, the management will continue to remain highly alert to the Company's business environment, and will face the difficulties on the grounds of prudence and progressiveness.

In 2003, we have overcome the SARS epidemic, successfully dealt with the challenges faced in exploration and development, continued to maintain a stable growth trend and achieved satisfactory results. In 2004, we will maintain our advantages of being a low-cost company and focus on production enhancement based on what we have achieved in the past few years. We will continue to implement our prudent financial policy, look for opportunistic oil and gas acquisitions and further expand the Company's natural gas business in order to deliver satisfactory return for our investors.

In 2004, six oil and gas projects in coastal China will commence production, allowing the Company to achieve its pre-set production target.

Given that the Company's balanced asset portfolios, progressive and enthusiastic management team, prudent financial policies and healthy financial position have already laid a solid foundation for our production and development, the management expresses optimism over the business prospects in 2004.

Consolidated Net Profit

Our consolidated net income after tax was RMB11,535.5 million (US$1,393.6 million) in 2003, an increase of RMB2,302.7 million (US$278.2 million), or 24.9% from RMB9,232.8 million in 2002.

Revenue

Our oil and gas sales for the year 2003 were RMB28,116.8 million (US$3,396.9 million), an increase of RMB4,337.5 million (US$524.0 million), or 18.2% from RMB23,779.3 million in 2002. The increase primarily reflects the rise in global crude oil prices and our production level. In 2003, as a result of the commencement of production in our new oil and gas properties as well as our successful acquisition of a portion of interests in Liuhua 11-1 and Qinhuangdao 32-6, our production volume increased compared to 2002. The average net production volume per day was 356,729 barrels in 2003, compared to 346,639 barrels in 2002, an increase of 3%. With the higher-than-expected oil price this year, our Indonesian oil and gas operations achieved a lower-than-expected net production volume based on the Indonesian oil production sharing contract, which affected the production volume growth. Our crude oil sales prices are determined in accordance with international crude oil prices. The international oil price in 2003 rose sharply compared with 2002. The average realised price for our crude oil was US$28.11 per barrel in 2003, an increase of US$3.76, or 15.4% from US$24.35 per barrel in 2002. The average realised price of natural gas was US$2.87 per thousand cubic feet in 2003, a decrease of US$0.11, or 3.7%, from US$2.98 per thousand cubic feet in 2002. The decrease was due to the lower natural gas price of our Indonesian properties and the Dongfang gas field which commenced production recently.

In 2003, our net marketing profit, which were derived from marketing revenue less purchase cost of crude oil and oil products, were RMB103.4 million (US$12.5 million), an increase of RMB52.3 million (US$6.3 million), or 102.3%, from RMB51.1 million in 2002. Since we are one of the three companies that have the right to sell crude oil in China, upon request by our partners, we can purchase the oil of these partners for sale in China.

However, our ability to sell oil in China depends on our foreign partners, and, therefore, we cannot control the amount of crude oil that we are able to sell for a specific period.

Our other income, reported on a net basis, was derived from our other income less corresponding costs. In 2003, the total other income was RMB84.5 million (US$10.2 million), a decrease of RMB101.7 million (US$12.3 million) from RMB186.2 million in 2002, resulting primarily from the decrease in project management fees.

Expenses

Operating expenses

Our operating expenses were RMB4,512.8 million (US$545.2 million) in 2003, an increase of RMB737.5 million (US$89.1 million), or 19.5%, from RMB3,775.3 million in 2002. The increase primarily resulted from operating expenses in connection with the Indonesian oil and gas properties, which were based on a full year's consolidated accounts as compared to the nine months contributions in 2002, and the commencement of operations in new properties. Operating expenses were RMB35.1 (US$4.25) per BOE in 2003, which were higher than operating expenses of RMB30.3 (US$3.66) per BOE in 2002. The increase was, on one hand, attributable to the higher operating expenses on a unit of production basis for the Indonesian oil and gas properties, resulting from the higher-than-expected oil price and lower net production, and its increased weighting in the Company on an annual production basis. On the other hand, the natural diminishing in old oilfield production and the higher maintenance cost also resulted in the slight increase in unit cost.

Production taxes

Our production taxes for the year 2003 were RMB1,238.6 million (US$149.6 million), an increase of 21.1%, or RMB215.6 million (US$26.0 million) from RMB1,023.0 million in 2002. The increase was due to increase in oil and gas sales in 2003.

Exploration costs

Our exploration costs for the year 2003 were RMB848.1 million (US$102.5 million), a decrease of RMB470.2 million (US$56.8 million), or 35.7%, from RMB1,318.3 million in 2002. The decrease primarily resulted from a higher successful rate of exploration and drilling activities.

Depreciation, depletion and amortisation expenses

Our depreciation, depletion and amortisation expenses for 2003 were RMB4,642.8 million (US$560.9 million), an increase of RMB623.3 million (US$75.3 million), or 15.5%, from RMB4,019.5 million in 2002. On a unit of production basis, depreciation, depletion and amortisation expenses for the year 2003 were RMB36.2 (US$4.37) per BOE, an increase of 12.0% compared to RMB32.3 (US$3.90) per BOE in 2002. The primary reason for the increase was the higher weighting for Indonesian oil and gas properties, which had a higher amortisation cost, and the increase in amortisation cost resulted from the reserve adjustment of some old fields.

Dismantlement

Our dismantlement costs for the year 2003 was RMB167.3 million (US$20.2 million), an increase of RMB41.2 million (US$5.0 million) from RMB126.1 million in 2002. The increase was primarily due to the increased dismantlement costs resulting from the commencement of production at new oil and gas properties. On a unit production basis, our dismantlement costs were RMB1.3 (US$0.16) per BOE, an increase of 30.0% compared to RMB1.0 (US$0.12) per BOE in 2002. The increase was primarily due to an upward revision of the estimated dismantlement costs and the increase in dismantlement costs resulting from the reserve adjustment of some old fields.

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Selling and administrative expenses

Our selling and administrative expenses for the year 2003 were RMB1,212.5 million (US$146.5 million), an increase of RMB206.0 million (US$24.9 million), or 20.5%, from RMB1,006.5 million in 2002. The primary reason for the increase was the selling and administrative expenses incurred in connection with the Indonesian oil and gas properties. On a unit of production basis, selling and administrative expenses were RMB9.4 (US$1.14) per BOE in 2003, an increase of 16.0% from RMB8.1 (US$0.98) per BOE in 2002. The increase was primarily attributable to the higher selling and administrative expenses on a unit of production basis for the Indonesian oil and gas properties, resulting from the higher-than-expected oil price and lower net production, and its increased weighting in the Company on an annual production basis. Our selling and administrative expenses in China in 2003 were RMB6.6 (US$0.8) per BOE, in line with the previous year.

Net interest expenses/income

Our net interest expense for 2003 was RMB171.4 million (US$20.7 million), in line with the net interest expense of RMB146.9 million in 2002.

Exchange Gain/Loss, net

Our exchange loss for 2003 was RMB6.7 million (US$0.8 million), a decrease of RMB107.1 million (US$12.9 million) when compared with an exchange loss of RMB113.8 million in 2002. The loss in 2002 was mainly attributable to exchange rate fluctuations related to our yen-denominated loans. Since we have prepaid a large portion of yen-denominated loans on 27 December 2002, and the outstanding amount of our yen-denominated loans is hedged using foreign currency swaps, we do not expect similar exchange gains or losses for that portion. Therefore, the exchange gain or loss this year was primarily attributable to the exchange gain generated from day-to-day operating activities.

Short term Investment Income

Our short term investment income for 2003 was RMB123.5 million (US$14.9 million), a decrease of RMB69.8 million (US$8.4 million) or 36.1% from RMB193.3 million in 2002. The decrease was primarily due to a decline in short term investment return in 2003.

Share of Profit of an Associate

Our share of profit of an associate for the year 2003 was RMB220.3 million (US$26.6 million), an increase of RMB54.9 million (US$6.6 million), or 33.2%, from RMB165.4 million in 2002. This item reflected our share of profit generated by Shanghai Petroleum and Natural Gas Company Limited , our associated company. This company experienced an increase of profit in 2003 resulting from an increase in output and oil prices.

Non-operating Income/Expenses, Net

Our net non-operating income for the year 2003 was RMB315.0 million (US$38.1 million), compared to non-operating expense for the year 2002 of RMB71.4 million. In 2003, the net non-operating income was mainly due to the tax refund from re-investment.

Tax

Our taxation for the year 2003 was RMB4,627.8 million (US$559.1 million), an increase of RMB1,086.4 million (US$131.3 million) or 30.7% from RMB3,541.4 million in 2002. The primary reason for the increase was the increase in profit before tax. The effective tax rate for 2003 was 28.6%, slightly higher than the effective rate of 27.7% in 2002.

Cash Generated from Operations

Net cash generated from operations in 2003 amounted to RMB17,818.7 million (US$2,152.8 million), an increase of RMB3,076.7 million (US$371.7 million), or 20.9%, from RMB14,742.0 million in 2002.

The increase in cash was mainly due to an increase in profit before tax of RMB3,389.1 million (US$409.5 million), an increase in depreciation, depletion and amortisation expenses of RMB623.2 million (US$75.3 million), an increase in dismantlement costs of RMB41.2 million (US$5.0 million), provision for inventory obsolescence of RMB8.7 million (US$1.1 million), and a decrease in short term investment income and amortisation of discount of long term guaranteed notes of RMB75.0 million (US$9.1 million), a increase of net interest expense of RMB24.4 million (US$3.0 million).

The increase of cash flow was partially offset by an increase of income tax of RMB 668.6 million (US$ 80.8 million), our share of income of an associate of RMB54.9 million (US$6.6 million) growth, a decrease of unpaid exchange loss of RMB107.1 million (US$12.9 million), and a decrease in loss on disposal and write off of property, plant and equipment of RMB398.0 million (US$48.1 million).

In addition, operating cash flow was increased due to the decrease of working capital, mainly due to the increase in current liabilities from operating activities of RMB935.0 million (US$113.0 million), and a simultaneous decrease in current assets from operating activities excluding cash and bank balances of RMB800.7 million (US$96.7 million).

Capital Expenditures and Investments

The cash outflow from investing activities in 2003 was RMB 9,512.6 million (US$1,149.3 million), a decrease of RMB 2,211.0 million (US$ 267.1 million) from RMB 11,723.6 million in 2002.

In line with our use of the successful efforts method of accounting, total capital expenditures and investments primarily include successful exploration and development expenditures. Total capital expenditures were RMB12,372.5 million (US$1,494.8 million) in 2003, an increase of RMB805.6 million (US$97.3 million), or 7.0%, from RMB11,566.9 million in 2002. Capital expenditures in 2003 mainly comprised RMB524.0 million (US$63.3 million) for capitalised exploration activities, RMB7,747.6 million (US$936.0 million) for development activities, and RMB4,100.9 million (US$495.5 million) for acquiring oil and gas properties (Tangguh, acquisition of Qinhuangdao 32-6 and Liuhua 11-1 interests). Our development expenditures in 2003 related principally to the development of Bozhong 25-1, Bonan, Weizhou 12-1 North, Dongfang 1-1, Caofeidian and Panyu 4-2/5-1, Huizhou 19-2/19-3 oil and gas fields.

We increased our investment in associated companies of RMB450.0 million (US$54.4 million). This cash outflow was partially offset by a decrease in time deposits with maturities over three months and short term investment, which were RMB2,367.0 million (US$286.0 million) and RMB942.9 million US$113.9 million) at the year end respectively.

Financing Activities

We had net cash outflows from financing activities of RMB1,744.9 million (US$210.8 million) in 2003, resulting primarily from our repayment of RMB336.9 million (US$40.7 million) in bank loans, dividend distributions of RMB5,403.7 million (US$652.8 million). This cash outflow was partly offset by net cash inflow of RMB3,995.8 million (US$482.8 million) resulting from our May 2003 offering of US$200 million in 4.125% 10-year guaranteed notes and US$300 million in 5.500% 30-year guaranteed notes.

The following table summarises the maturities of our long-term debt outstanding as of 31 December 2003.

Debt maturities principal only

Original currency

Due by 31 December	US$	JPY	RMB	Total RMB equivalents	Total US$ equivalents
				(In millions, except percentages)	
2004	–	271.5	–	21.0	2.5
2005-2007	100.0	814.4	–	890.6	107.6
2008-2009	–	–	–	–	–
2010 and beyond	1,000.0	–	–	8,276.7	1,000.0
Total	1,100.0	1,085.9	–	9,188.3	1,110.1
Percentage of total debt	99.1%	0.9%	–	100.0%	100.0%

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On 31 December 2003, our gearing ratio was 57.3%. Gearing ratio is calculated as total liabilities/equity.

Market Risks

Our market risk exposures primarily consists of fluctuations in oil and gas prices, exchange rates and interest rates.

Commodity price risk:

We are exposed to fluctuations in prices of crude oil and natural gas, which are commodities whose prices are determined by reference to international market prices. International oil and gas prices are volatile and this volatility has a significant effect on our net sales and net income.

Currency risk:

Our foreign exchange exposure gives rise to market risk associated with exchange rate movements.

Substantially all of our oil and gas sales are denominated in Renminbi and U.S. dollars. In the last ten years, the PRC government's policy of maintaining a stable exchange rate and China's ample foreign reserves have contributed to the stability of the Renminbi. Recently, there has been wide expectation in the international market that the Chinese government will deregulate the Renminbi exchange rate. However, the Chinese government has not yet determined if or when the exchange rate will be deregulated. Currently, the Renminbi exchange rate remains stable.

In case of any Renminbi exchange rate deregulation going forward, our existing assets denominated in U.S. dollars will face book conversion risks from the appreciation of Renminbi.

As we prepaid the majority of our yen-denominated loans in 2002, the balance of our yen-denominated loans as of the end of 2003 was only 1.09 billion yen. Currently, since this outstanding amount of our yen loans is hedged against foreign currency swaps, we do not expect any exchange risks relating to Japanese yen in the future.

Interest rate risk:

As of the end of 2003, all our foreign currency debts are at fixed interest rates. To balance our overall debt interest structure and to reduce our financial cost benefiting from the low interest rate market environment, during the period from July to September 2003, we arranged for a plain vanilla interest rate swap with three financial institutions by swapping the new offering of US$200 million 10-year global guaranteed notes in 2003 into floating interest rate. After the swap, we received fixed interest rate of 4.125% and paid floating interest rate at LIBOR -0.771% (weighted average interest rate). During the first interest swap in November 2003, LIBOR was only 1.2% approximately. Through the present swap, we managed to make interest savings of US$2.02 million.

Based on the series of robust economic data announced by the US in late 2003, we believed that the US economy had entered into a rapid growth period, with interest rate taking an upward trend. In January 2004, we captured the opportunity of significant drop of US treasury yield with the US's announcement of the poor performance of certain economic data, and terminated the above interest swap arrangement with net gains of US$10 million. This, in addition to the interest savings of US$2.02 million for the year 2003, resulted in cumulative net gains of US$12.02 million, representing the reduction of interest rate of the US$200 million guaranteed notes from 4.125% to 3.53%.

Significant Investments and Material Acquisitions

Our acquisition of interest in the Tangguh Project from BP was completed. With effect from 1 January 2003, the Company became a partner with 12.5% interest in the Tangguh Project.

On 15 May 2003, we entered into a purchase agreement with the partners of the North West Shelf natural gas venture ("North West Shelf Venture") for the acquisition of output and reserves interest of its upstream oilfields. CNOOC Ltd will assume a 25% interest in the China LNG Joint Venture ("CLNG JV"), a joint venture to be established within the North West Shelf Venture. The acquisition price for this project was US$348 million. If the ultimate gas supply of the Guangdong LNG project increases, the interest acquired by the Company will increase and the consideration paid by the Company to acquire such interests will also increase correspondingly. This acquisition project is not yet completed.

On 24 October 2003, we entered into a new agreement with the venture participants of the Gorgon project in Australia based on the memorandum of understanding previously entered into with them. According to that agreement, after the signing and completion of the formal contract, CNOOC Ltd will acquire certain interest in the Gorgon natural gas project.

The Company expects to fund the above two acquisitions principally from its operating cashflow and funds raised from its issue of bonds.

Employees

We had 2,447 employees as at 31 December 2003.

To ensure the smooth implementation of our overseas strategy, we have established an international human resources system to attract and retain our management and technical talents.

We have adopted three stock option schemes for our senior management since 4 February 2001, and granted options under each of the Schemes.

In 2003, in line with our development strategy, we carried out a systematic and in-depth recruitment and remuneration system reform focusing on our overall and future developments. To ensure the reform achievements, we further enhanced the establishment and improvement of our internal human resources system. During the year, we established a simple but effective employee performance evaluation system emphasizing on the integration of the individual's development objectives and the Company's operating targets, and which was linked up with international employee performance evaluation system.

Through the establishment and promotion of individual development schemes and systems, we managed to organize and implement various specialized and comprehensive management training courses. During the year, a total of 325 training courses in various areas were carried out, which were attended by more than 6,980 participants.

At the same time, the Company attached great emphasis to the advanced management training of senior management officers and management technique for mid-level managers.