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

In reviewing the following discussion, please also refer to the consolidated financial statements of the Company and its subsidiaries (the "**Group**") and their notes contained in this annual report.

Overview

For the twelve months ended December 31, 2003, profit before taxation of the Group was RMB98,322 million, representing an increase of 42.00% compared with the corresponding period in the previous year. Net profit was RMB69,614 million, representing an increase of 48.40% compared with the corresponding period in the previous year. For the first time profit was recorded in all four business segments. The increase in profit was due primarily to the Group's ability to take full advantage of the opportunities presented by high oil prices, to actively adjust its crude oil production in the east as well as to speed up production in the west, thereby achieving a stable increase in domestic crude oil production. In terms of natural gas business, production was sped up mainly in the top four gas production areas and substantial efforts were made to expand the market, leading to persistent and fast growth in both production and sales volume. With regard to refining and chemicals business, equal emphasis was put on structural adjustments and enhancement of management, the highest ever crude oil processing load factor was attained while substantial efforts were made to increase the production of products with high added value and meeting the needs of the market. The marketing business responded proactively to market changes and made timely adjustments to marketing strategies, resulting in significant growth both in the total sales volume and the retail volume.

Basic and diluted earnings per share of the Company for the twelve months ended December 31, 2003 was RMB0.40.

Twelve Months Ended December 31, 2003 Compared With Twelve Months Ended December 31, 2002

Consolidated Operating Results

◆ Turnover

Turnover increased 24.28% from RMB244,424 million for the twelve months ended December 31, 2002 to RMB303,779 million for the twelve months ended December 31, 2003. This was due primarily to the increase in the price of crude oil and the increase in the sales volume and prices of refined products and chemical products.

◆ Operating Expenses

Operating expenses increased 18.89% from RMB172,083 million for the twelve months ended December 31, 2002 to RMB204,593 million for the twelve months ended December 31, 2003. This was due primarily to the increased expenses in purchasing crude oil and refined products from external suppliers.

◆ Purchases, Services and Other Expenses

Purchases, services and other expenses increased 26.73% from RMB71,690 million for the twelve months ended December 31, 2002 to RMB90,850 million for the twelve months ended December 31, 2003. This mainly reflects: (i) the increase in the procurement cost for crude oil corresponding to the increase in the refining volume of the refineries; and (ii) the increase in the price of refined products resulting in the increased expenses in purchasing refined products from external suppliers.

◆ Employee Compensation Costs

Employee compensation costs increased 20.27% from RMB16,248 million for the twelve months ended December 31, 2002 to RMB19,542 million for the twelve months ended December 31, 2003. This was due primarily to an increase in employees' salaries and welfare expenses corresponding to better operating results of the Company this year and an increase in labour expenses as a result of the development of the retail distribution network.

◆ Depreciation, Depletion and Amortisation

Depreciation, depletion and amortisation increased 10.19% from RMB36,782 million for the twelve months ended December 31, 2002 to RMB40,531 million for the twelve months ended December 31, 2003. This was due primarily to an increase in depreciation expenses resulting from the addition of new assets.

◆ Selling, General and Administrative Expenses

Selling, general and administrative expenses increased 6.48% from RMB22,474 million for the twelve months ended December 31, 2002 to RMB23,930 million for the twelve months ended December 31, 2003. This increase was due primarily to the higher impairment of receivables. The Company was able to keep such expenses under effective control while continuing to increase its scale and achieving a fairly significant increase in its sales volume.

◆ Shut Down of Manufacturing Assets

The costs for shutting down manufacturing assets increased by 11.03% from RMB2,121 million for the twelve months ended December 31, 2002 to RMB2,355 million for the twelve months ended December 31, 2003, including RMB1,596 million for shutting down refining assets with low efficiency in the refining and marketing segment, and RMB759 in the chemicals and marketing segment.

◆ Taxes Other than Income Taxes

Taxes other than income taxes increased 8.66% from RMB14,613 million for the twelve months ended December 31, 2002 to RMB15,879 million for the twelve months ended December 31, 2003. This was due primarily to: (i) increases in the production of gasoline and diesel products resulting in higher consumption tax and surcharges; and (ii) an increase in revenue resulting in an increase in resources compensation fees.

◆ Profit From Operations

Profit from operations increased 37.11% from RMB72,341 million for the twelve months ended December 31, 2002 to RMB99,186 million for the twelve months ended December 31, 2003.

◆ Net Exchange Gain (Loss)

Net exchange loss decreased 43.04% from RMB316 million for the twelve months ended December 31, 2002 to RMB180 million for the twelve months ended December 31, 2003. This was due primarily to a decrease in the average proportion of foreign exchange borrowings and an adjustment in the currency mix of foreign exchange borrowings by repaying some of the foreign debts denominated in foreign currencies with relatively high exchange rate risk, such as Euro and British Sterling.

◆ Net Interest Expense

Net interest expense decreased 45.33% from RMB3,053 million for the twelve months ended December 31, 2002 to RMB1,669 million for the twelve months ended December 31, 2003. This decrease was due primarily to sufficient cash flow generated by operating activities, a decrease in average proportion of interest-bearing debts, and decreases in the average interest rates.

◆ Profit Before Taxation

Profit before taxation increased 42.00% from RMB69,240 million for the twelve months ended December 31, 2002 to RMB98,322 million for the twelve months ended December 31, 2003.

◆ Taxation

Taxation increased 26.27% from RMB22,231 million for the twelve months ended December 31, 2002 to RMB 28,072 million for the twelve months ended December 31, 2003 due primarily to an increase in profit before taxation.

◆ Net Profit

Net profit increased 48.40% from RMB46,910 million for the twelve months ended December 31, 2002 to RMB69,614 million for the twelve months ended December 31, 2003.

Segment Information

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

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 increased 20.34% from RMB147,308 million for the twelve months ended December 31, 2002 to RMB 177,271 million for the twelve months ended December 31, 2003. This was due primarily to an increase in the price of crude oil and the increased sales volume of natural gas. The average realised price of crude oil of the Company in 2003 was US$27.20 per barrel, increased by 21.00% as compared with 2002.

Intersegment sales increased 21.36% from RMB106,266 million for the twelve months ended December 31, 2002 to RMB128,963 million for the twelve months ended December 31, 2003. This was due primarily to an increase in the price of crude oil and the increased sales volume of natural gas.

◆ Operating Expenses

Operating expenses increased 12.95% from RMB75,169 million for the twelve months ended December 31, 2002 to RMB84,901 million for the twelve months ended December 31, 2003 due primarily to an increase in exploration expenses, depletion of oil and gas property, human resources expenses and higher impairment of receivables.

◆ Profit From Operations

Profit from operations increased 28.04% from RMB72,139 million for the twelve months ended December 31, 2002 to RMB92,370 million for the twelve months ended December 31, 2003.

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 increased 28.04% from RMB174,621 million for the twelve months ended December 31, 2002 to RMB223,584 million for the twelve months ended December 31, 2003 due to increases in the sales volume and prices of major refined products.

Sales revenue from gasoline increased 23.02% from RMB48,834 million for the twelve months ended December 31, 2002 to RMB60,073 million for the twelve months ended December 31, 2003 due primarily to an increase in the selling price and sales volume. The average realised selling price of gasoline increased 17.62% from RMB2,570 per ton for the twelve months ended December 31, 2002 to RMB3,023 per ton for the twelve months ended December 31, 2003. The sales volume of gasoline increased 4.59% from 19 million tons for the twelve months ended December 31, 2002 to 19.87 million tons for the twelve months ended December 31, 2003.

Sales revenue from diesel increased 26.88% from RMB79,081 million for the twelve months ended December 31, 2002 to RMB100,336 million for the twelve months ended December 31, 2003 due primarily to an increase in the selling price and sales volume. The average realised selling price of diesel increased 14.72% from RMB2,384 per ton for the twelve months ended December 31, 2002 to RMB2,735 per ton for the twelve months ended December 31, 2003. The sales volume of diesel increased 10.59% from 33.17 million tons for the twelve months ended December 31, 2002 to 36.68 million tons for the twelve months ended December 31, 2003.

Sales revenue from kerosene increased 6.76% from RMB3,864 million for the twelve months ended December 31, 2002 to RMB4,125 million for the twelve months ended December 31, 2003 due primarily to an increase in the selling price.

Intersegment sales revenue increased 68.87% from RMB9,988 million for the twelve months ended December 31, 2002 to RMB16,867 million for the twelve months ended December 31, 2003 due primarily to increases in the price and sales volume of refined products.

◆ Operating Expenses

Operating expenses increased 27.21% from RMB171,803 million for the twelve months ended December 31, 2002 to RMB218,549 million for the twelve months ended December 31, 2003 due primarily to the increased expenses in purchasing of crude oil and refined products from external suppliers.

◆ Profit From Operations

Profit from operations increased 78.67% from RMB2,818 million for the twelve months ended December 31, 2002 to RMB5,035 million for the twelve months ended December 31, 2003.

Chemicals and Marketing

The Chemicals and Marketing segment is engaged in the production and sale of petrochemical products, derivative petrochemical products and other chemical products.

◆ Turnover

Turnover increased 32.20% from RMB29,661 million for the twelve months ended December 31, 2002 to RMB39,211 million for the twelve months ended December 31, 2003. This significant improvement in the results of this segment was due primarily to increases in the sales volume and prices of chemical products.

◆ Operating Expenses

Operating expenses increased 16.29% from RMB32,823 million for the twelve months ended December 31, 2002 to RMB38,170 million for the twelve months ended December 31, 2003 due primarily to an increase in the purchase expenses for direct materials.

◆ Profit From Operations

The chemicals and marketing segment made a profit from operations of RMB1,041 million for the twelve months ended December 31, 2003, compared with 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 natural gas, crude oil and refined products and the sale of natural gas.

◆ Turnover

Turnover increased 18.33% from RMB12,733 million for the twelve months ended December 31, 2002 to RMB15,067 million for the twelve months ended December 31, 2003 due primarily to increases in the sales volume of natural gas, the average pipeline transmission price for crude oil and natural gas and the income from pipeline transmission for refined products.

◆ Operating Expenses

Operating expenses increased 17.57% from RMB11,181 million for the twelve months ended December 31, 2002 to RMB13,145 million for the twelve months ended December 31, 2003. This was due primarily to an increase in the purchase expenses for natural gas and depreciation expenses.

◆ Profit From Operations

Profit from operations increased 23.84% from RMB1,552 million for the twelve months ended December 31, 2002 to RMB1,922 million for the twelve months ended December 31, 2003.

Liquidity and Capital Resources

For the twelve months ended December 31, 2003, the Group's primary sources of funding were cash generated from operating activities, short-term and long-term borrowings, cash and cash equivalents. The Group's funds were primarily used in operating activities, for capital expenditures, repayment of short-term and long-term borrowings, and distributions of dividends to shareholders.

As at December 31, 2003, short-term borrowings made up approximately 6.67% of the capital employed compared with approximately 5.12% as at December 31, 2002. The ability to obtain financing may be affected by the financial position and the results of operations of the Company, and by the conditions of international and domestic capital markets. In addition, prior to accessing international capital markets, the Company must obtain approvals from relevant PRC government authorities. In general, the Company must obtain PRC government approvals for any project involving significant capital investment in the refining and marketing segment, chemicals and marketing segment and the natural gas and pipeline segment.

The Company plans to fund the capital and related investments principally through the cash flow generated from operating activities, short-term and long-term borrowings, cash and cash equivalents. A net cash flow of RMB138,820 million was generated from operating activities for the twelve months ended December 31, 2003. As at December 31, 2003, the Group had RMB11,231 million in cash and cash equivalents. Cash and cash equivalents were primarily Renminbi (with Renminbi accounting for approximately 91.68% and United States Dollar accounting for approximately 8.32%).

The table below sets forth the cash flow of the Group for each of the twelve months ended December 31, 2002 and 2003 and the cash equivalents at the end of each period:

	Year ended December 31,	
	2003	2002
	RMB (million)	RMB (million)
Net cash flow generated from operating activities	138,820	98,341
Net cash flow used for investing activities	(97,797)	(71,662)
Net cash flow used for financing activities	(39,769)	(27,829)
Cash and cash equivalents at the end of each period	11,231	9,977

Cash Flow Generated from Operating Activities

The net cash flow of the Group generated from operating activities increased from RMB98,341 million for the twelve months ended December 31, 2002 to RMB138,820 million for the twelve months ended December 31, 2003. This was due primarily to an increase in sales revenue, the timely collection of payment for goods, and increased efforts in clearing old receivables.

As at December 31, 2003, the Group had a working capital deficit of RMB27,855 million, compared with a working capital deficit of RMB14,189 million as at December 31, 2002. This increase in working capital deficit was due to an increased amount of long-term borrowings due within a year.

Cash Used for Financing Activities

The net borrowings of the Group as at December 31, 2002 and December 31, 2003 were as follows:

	Year ended December 31	
	2003	2002
	RMB (million)	RMB (million)
Short-term borrowings (including liquid portion of long-term borrowings)	28,890	20,633
Long-term borrowings	41,959	60,655
Total borrowings	70,849	81,288
Less:		
Cash and cash equivalents	11,231	9,977
Time deposits with maturities over three months	2,640	2,612
Receivables under resale agreements	24,224	9,786
Net borrowings	32,754	58,913

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

	Principal as at December 31, 2003
	RMB (million)
To be repaid within one year	19,711
To be repaid within one to two years	18,183
To be repaid within two to five years	17,108
To be repaid after five years	6,668
	61,670

Of the total borrowings of the Group as at December 31, 2003, approximately 24.03% were fixed-rate loans and 75.97% were floating-rate loans. Of the borrowings as at December 31, 2003, approximately 81.95% were denominated in Renminbi, approximately 16.05% in United States Dollar, approximately 0.64% in British Sterling, approximately 0.82% in Japanese Yen and approximately 0.54% in Euro.

As at December 31, 2002 and December 31, 2003, the amount of short-term borrowings owed to related parties was RMB570 million and RMB610 million, respectively. As at December 31, 2002 and December 31, 2003, the amount of long-term borrowings owed to related parties was RMB24,132 million and RMB24,578 million, respectively.

As at December 31, 2003, the amount of short-term and long-term borrowings owed to China Petroleum Finance Company Limited was RMB610 million and RMB24,578 million, respectively.

The net cash flow used for financing activities for the twelve months ended December 31, 2003 increased 42.90% compared with the twelve months ended December 31, 2002. This increase was primarily due to increased dividend payment.

As at December 31, 2003, RMB170 million worth of loans made to the Group (RMB398 million in 2002) were secured loans (finance lease and bank loans), of which RMB114 million worth of bank loans (RMB276 million in 2002) were secured by plant and equipment of the Group that worth RMB152 million (RMB426 million in 2002). 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, 2003, the debts incurred by the Group by way of finance lease amounted to RMB56 million (RMB122 million in 2002). The net book value of the property, plant and equipment under finance lease was RMB240 million (RMB399 million in 2002).

The debt to capitalisation ratio as at December 31, 2003 was 16.57% (20.43% as at December 31, 2002).

Capital Expenditures

The table below sets forth capital expenditures of the Group by business segment for each of the twelve months ended December 31, 2003 and the twelve months ended December 31, 2002. Capital expenditures increased 14.34% from RMB73,726 million as at December 31, 2002 to RMB84,299 million as at December 31, 2003. This was due primarily to increased investments in exploration, the speeding up of production in the west and greater efforts in the construction of the sales network.

Year ended December 31,	**2003**		**2002**		**2004(estimated value)**	
	RMB (million)	%	**RMB** (million)	%	**RMB** (million)	%
Exploration and Production	52,813*	62.65	46,078*	62.50	52,070*	60.78
Refining and marketing	13,915	16.51	11,327	15.36	10,100	11.79
Chemicals and marketing	3,903	4.63	3,175	4.31	5,500	6.42
Natural gas and pipeline	13,530	16.05	13,013	17.65	17,400	20.31
Other	138	0.16	133	0.18	600	0.70
Total	84,299	100.00	73,726	100.00	85,670	100.00

Note*: If the investments relating to geological and geophysical exploration costs are included, the capital expenditures and investments for the exploration and production segment for 2002, 2003 and the estimated value for the year of 2004 will be RMB50,646 million, RMB58,699 million and RMB56,900 million, respectively.

Exploration and Production

The majority of the Group's capital expenditures relate to the exploration and production segment. Capital expenditures of the exploration and production segment for the twelve months ended December 31, 2003 were RMB52,813 million, of which RMB9,250 million was used for exploration activities and RMB39,587 million for development activities. The capital expenditures of this 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. The increase in the capital expenditures was due primarily to increased investments in exploration, the strategic adjustments in the east and the speeding up of production in the west.

The Group anticipates that capital expenditures for the exploration and production segment for the twelve months ending December 31, 2004 will amount to RMB52,070 million. Approximately RMB9,870 million will be used for oil and gas exploration activities and approximately RMB42,200 million for oil and gas development activities. The exploration efforts will be focused on the Erdos, Junggar, Tarim, Songliao and Bohai Bay basins.

Refining and Marketing

Capital expenditures for the Group's refining and marketing segment for the twelve months ended December 31, 2003 were RMB13,915 million, of which RMB8,573 million was spent on the expansion of the retail marketing network for refined products and basic storage facilities, and RMB5,342 million was spent on the renovation of the refining facilities. The total capital expenditures of this segment for the twelve months ended December 31, 2002 were RMB11,327 million. The increase in capital expenditures was due primarily to greater efforts in the construction of the sales network.

The Group anticipates that capital expenditures for the refining and marketing segment for the twelve months ending December 31, 2004 will amount to RMB10,100 million, which include:

- approximately RMB4,600 million for the construction and expansion of refining facilities;

- approximately RMB5,500 million for investments in the refined product sales network in order to increase the number of service stations and storage facilities.

Chemicals and Marketing

Capital expenditures for the chemicals and marketing segment increased 22.93% from RMB3,175 million for the twelve months ended December 31, 2002 to RMB3,903 million for the twelve months ended December 31, 2003. The increase in capital expenditures was due primarily to increased investments in the ethylene project of Daqing Petrochemical Company, and the launching of a number of new construction projects, such as the upgrading of facilities for organosilicon polymer and butanol/octanol in Jilin Petrochemical Company.

The Group anticipates that capital expenditures for the chemicals and marketing segment for the twelve months ending December 31, 2004 will amount to RMB5,500 million, which is expected to be used primarily for the upgrading of the three big ethylene projects at Daqing, Jilin and Lanzhou, and for the launching of three chemical fertilizer production capacity expansion projects at Daqing, Ningxia and Urumqi petrochemical companies, and the PTA project at Liaoyang Petrochemical Company.

Natural Gas and Pipeline

Capital expenditures in the natural gas and pipeline segment for the twelve months ended December 31, 2003 were RMB13,530 million. The Group spent RMB13,276 million of these capital expenditures on the construction of long distance pipelines, of which RMB10,667 million was spent on the West-East gas pipeline project. Capital expenditures in this segment for the twelve months ended December 31, 2002 totalled RMB13,013 million. The increase in the capital expenditures was due primarily to increased investments in the West-East gas pipeline project, the Zhongxian-Wuhan and the second Shaanxi-Beijing pipelines.

The Group anticipates that capital expenditures for the natural gas and pipeline segment for the twelve months ending December 31, 2004 will amount to RMB17,400 million. Approximately RMB13,400 million is expected to be invested in the West-East gas pipeline project, the Zhongxian-Wuhan pipeline and the second Shaanxi-Beijing pipeline projects, approximately RMB4,000 million is expected to be invested in the construction of natural gas storage facilities and other natural gas, crude oil and refined products pipelines.

Other

Non-segment-specific capital expenditures for the twelve months ended December 31, 2002 and the twelve months ended December 31, 2003 were RMB133 million and RMB138 million, respectively. The capital expenditures related primarily to non-segment-specific equipment purchases and research and development activities.

The Group anticipates that its non-segment-specific capital expenditures for the twelve months ending December 31, 2004 will amount to RMB600 million, which is expected to be primarily used for the construction of water and electricity supply systems, roads and telecommunications systems for the benefits of various segments.

Material Investment

The Group did not hold any material investment for the year ended December 31, 2003.

Material Acquisition or Disposal

The Group had no material acquisition or disposal of subsidiaries and associated companies in the year ended December 31, 2003.

Foreign Exchange Rate Risk

Renminbi is not a freely convertible currency. Future exchange rates of Renminbi could vary significantly from the current or historical exchange rates as a result of controls that could be imposed by the PRC government. The exchange rates of Renminbi are affected by changes in PRC government policies. The exchange rates of Renminbi are also affected by economic developments and political changes domestically and internationally, and supply and demand for Renminbi. The official exchange rate for the conversion of Renminbi to United States Dollar has generally been stable recently. As Renminbi is the measurement currency of the Company and most of its consolidated entities, the fluctuation of exchange rates of Renminbi may have positive or negative impacts on the results of operations of the Group. Because prices for the Group's crude oil and refined products are set generally with reference to United States Dollar-denominated international prices, a devaluation of Renminbi against United States Dollar may not have a negative impact on the Group's revenue, but may increase the cost incurred by the Group to acquire imported materials and equipment as well as the foreign currency-denominated obligations of the Group. On the other hand, an appreciation of Renminbi against United States Dollar may decrease the Group's revenue, but the cost for acquiring imported materials and equipment may be reduced. The results of operations and the financial position of the Group may also be affected by fluctuations in exchange rates against Renminbi of a number of other foreign currencies other than United States Dollar.

Commodity Price Risk

The Group is engaged in a broad range of petroleum related activities. The hydrocarbon commodity markets are influenced by global as well as regional supply and demand conditions. The PRC government currently publishes prices for onshore crude oil, gasoline and diesel according to international benchmark prices. A decline in prices of crude oil and refined products could adversely affect its financial performance. The Group historically has not used commodity derivative instruments to hedge the potential price fluctuations of crude oil and other refined products. Therefore, during 2003 and 2002, the Group was exposed to the general price fluctuations of broadly traded oil and gas commodities.

Industry Risk

Like other crude oil and natural gas companies in China, the Company's business activities are subject to regulation and control by the PRC government in many aspects. This regulation and control, such as by way of grant of exploration and production licenses, the imposition of industry-specific taxes and levies and the implementation of environmental and safety standards, is expected to have an effect on the Company's business operations. As a result, the Company may be subject to fairly significant restrictions when implementing its business strategy, developing and expanding its business or maximising its profitability. Any future changes in PRC governmental policies on the crude oil and natural gas industry may also affect the Company's business operations.

Employees

◆ Number of Employees

As at December 31, 2002 and December 31, 2003, the Group had 419,598 and 417,229 employees, respectively. The table below sets forth the number of the employees by business segment as at December 31, 2003:

	Number of Employees	% of total
Exploration and production	234,733	56.00
Refining and marketing	111,655	27.00
Chemicals and marketing	57,722	14.00
Natural gas and pipeline	10,342	2.00
Other*	2,777	1.00
Total	417,229	100.00

Note*: Including PetroChina Exploration & Development Research Institute, PetroChina Planning & Engineering Institute, headquarters and business segments.

◆ Employee Compensation

The total employee compensation payable by the Group for the twelve months ended December 31, 2003 was RMB12,893 million, being the total salaries of the employees during the reporting period. Compensation of the employees is determined according to industry practice and the actual conditions of the Group, 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.

The Company's senior management remuneration system links senior management members' financial interests (including those of executive directors and supervisors) with the Company's operating results and the market performance of its shares. The senior management members have entered into performance contracts with the Company. 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 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, 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 as at December 31, 2003 and December 31, 2002 are as follows:

	Year ended December 31	
	2003	**2002**
	RMB('000)	**RMB('000)**
Fee for directors and supervisors	83	128
Salaries, allowances and other benefits	1,377	1,042
Contribution to retirement benefit scheme	34	25
	1,494	1,195

The numbers of directors and supervisors whose emoluments fall within the following band (including directors and supervisors whose term expired during the year):

	2003 Number	**2002 Number**
Nil - RMB1,000,000	19	23

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

During the period from 1999 to 2002, a total of 58,300 people were laid off, which has met the target of laying off 50,000 employees committed originally by the Company.

The Company has no plan for any substantial reduction of its workforce in the next few years, but will continue to keep a strict control on the total number of employees. Workforce required for new projects or expanded production capacity will first be obtained by way of tapping existing resources and making use of any spare capacity, with the aim of keeping the workforce at its present size. The target is to maintain zero growth in head count while striving to reduce head count.

◆ Training Programmes

In order to develop the Company into a first-class international oil company, the Company will endeavour to carry out its training programmes this year with a special emphasis on learning. It will focus on the training of core employees, actively train all its employees and strive to build up an operating and management team, a technology renovation team and an skillful operators' team, so as to achieve an overall improvement in the quality of its staff and ensure the supply of talents required for the continuous, steady and rapid development of the Company.

◆ Medical Insurance

Since October 1, 2002, the Company's headquarters and its regional branches based in Beijing have participated in the basic medical insurance scheme organised by the Beijing Municipality, making contributions at 9% of the total basic salaries of the employees. Other regional branches of the Company have also participated in the respective local basic medical insurance scheme.

As basic medical insurance is organised by the local government, the implementation dates vary and there are certain differences between the rate of contribution and reimbursement methods adopted by various cities. The rate of contribution is usually set at 6% to 10% of the total basic salaries of the employees of the respective companies.

In accordance with relevant regulations of the State, the Company has given permission to regional branches which have already participated in the local basic medical insurance scheme to establish supplemental medical insurance scheme beginning from 2002. Contributions to such supplemental scheme must not exceed 4% of the total salaries and will be booked as cost.

Contingent Liabilities

Information on the Group's contingent liabilities as of December 31, 2003 is as follows:

◆ Bank and other guarantees

At December 31, 2003, 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.

	December 31, 2003 RMB (million)	**December 31, 2002 RMB (million)**
Guarantees in respect of borrowings of associated companies	448	962

◆ Environmental liabilities

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, and could be material. Under the existing legislation, however, the management of the Group believes that there are no probable environmental liabilities, except for the 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 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 land, roads and buildings

According to the Restructuring Agreement entered into between the Company and CNPC in 1999 upon the incorporation of the Company, 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 December 31, 2003, CNPC had obtained formal land use right certificates in relation to 24,046 out of the above-mentioned 28,649 parcels of land and some building ownership certificates for the above-mentioned buildings, but had not yet completed the necessary governmental procedures for the above-mentioned service stations located on collectively-owned land. The directors of the Company are of the opinion 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 by CNPC or the fact that the relevant governmental procedures have not been completed. In the management's opinion, the outcome of the above events will not have a 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 damage or business interruption insurance since such insurance coverage is not customary in China. While the effect of under-insurance on future incidents cannot be reasonably assessed at present, the management of the Group believes that it may have a material impact on the operating results, but will not have a material adverse effect on the financial position of the Group.

◆ Re-allocation of production facilities

The Group may further streamline its production facilities within the next several years to further improve the competitiveness and operating efficiency of the Group. The management has not approved all significant actions to be taken to complete such plans. The management believes such plans will not have a material adverse impact on the Group's financial position, but they may have a material adverse effect on the Group's results of operations.