MANAGEMENTS DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the consolidated interim condensed financial statements for the Group and the notes thereto.

Overview

For the six months ended June 30, 2004, the profit before taxation of the Group was RMB64,045 million, representing an increase of 18.35% from the corresponding period of last year. Net profit was RMB45,292 million, representing an increase of 17.28% from the corresponding period of last year. The continued rapid improvement of the Company's operating results was attributable to the streamlining of production activities and enhancement of operation management during a period of continuous and rapid economic growth, sustained high oil prices and strong demand for oil and petrochemical products.

For the six months ended June 30, 2004, the Company's basic and diluted earnings per share was RMB0.26.

Comparison between the six-month period ended June 30, 2004 and the six-month period ended June 30, 2003

Consolidated Operating Results

Turnover Turnover increased 21.35% from RMB147,960 million for the six months ended June 30, 2003 to RMB179,552 million for the six months ended June 30,2004. The growth was mainly attributable to the increase in prices of crude oil, the increase in the prices and sales volume of refined products and chemicals, and the rise in the sales volume of natural gas.

Operating Expenses Operating expenses increased 24.03% from RMB92,965 million for the six months ended June 30, 2003 to RMB115,302 million for the six months ended June 30, 2004. The change was mainly attributable to an increase in the purchase of oil from external suppliers and increased depreciation, depletion and amortization caused by an increase in the amount of property, plant and equipment.

Purchases, Services and Other Expenses Purchases, services and other expenses increased 30.23% from RMB40,465 million for the six months ended June 30, 2003 to RMB52,699 million for the six months ended June 30, 2004. This was due primarily to the increase in the purchase cost of crude oil resulted from the increase of crude oil price and the increase in the purchase volume of crude oil by the Company's refineries.

Employee Compensation Costs Employee compensation costs rose 26.73% from RMB8,275 million for the six months ended June 30, 2003 to RMB10,487 million for the six months ended June 30, 2004. This was due primarily to the increase in the wages and welfare expenses of staff and workers as a result of strong operating results achieved by the

Company, and the increase in labour service costs as a result of further development of the Company’s retail network.

Depreciation, Depletion and Amortization Depreciation, depletion and amortization increased 18.00% from RMB20,909 million for the six months ended June 30, 2003 to RMB24,673 million for the six months ended June 30, 2004. This was mainly attributable to an increase in impairment of assets, and increase in depreciation and depletion and amortization caused by an increase in the amount of property, plant and equipment.

Selling, General and Administrative Expenses Selling, general and administrative expenses increased 15.16% from RMB11,094 million for the six months ended June 30, 2003 to RMB12,776 million for the six months ended June 30, 2004. This was due primarily to an increase in transportation and storage costs caused by an increase in the sales volume of refined oil and petrochemical products.

Taxes other than Income Tax Taxes other than income tax increased 17.95% from RMB7,872 million for the six months ended June 30, 2003 to RMB9,285 million for the six months ended June 30, 2004. The increase was due primarily to an increase in consumption tax and surcharges as a result of an increase in the sales volume of gasoline and diesel oil by the Company’s refineries.

Profit from Operations As a result of the factors discussed above, profit from operations advanced 16.83% from RMB54,995 million for the six months ended June 30, 2003 to RMB64,250 million for the six months ended June 30, 2004.

Net Exchange Gain (Loss) A turn from net exchange loss of RMB64 million for the six months ended June 30,2003 to a net exchange gain of RMB10 million for the six months ended June 30, 2004 was recorded. The turnaround was due primarily to a depreciation of value of the Japanese Yen and the Euro against Renminbi of 1.17% and 2.63% respectively during the first half of this year. During the corresponding period of last year, the value of the Euro and the British Sterling appreciated against Renminbi significantly.

Net Interest Expenses Net interest expenses decreased 16.74% from RMB1,123 million for the six months ended June 30, 2003 to RMB935 million for the six months ended June 30, 2004. The decrease in net interest expenses was due primarily to the increase in interest income resulted from sufficient cash flow generated from operating activities.

Profit Before Taxation Profit before taxation rose 18.35% from RMB54,116 million for the six months ended June 30, 2003 to RMB64,045 million for the six months ended June 30, 2004.

Taxation Taxation increased 18.54% from RMB15,201 million for the six months ended June 30, 2003 to RMB18,019 million for the six months ended June 30, 2004. The increase was mainly due to an increase in taxable profits.

Net Profit As a result of the factors discussed above, net profit increased 17.28% from RMB38,619 million for the six months ended June 30, 2003 to RMB45,292 million for the six months ended June 30, 2004.

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 sales of crude oil and natural gas.

Turnover Turnover increased 8.79% from RMB91,485 million for the six months ended June 30, 2003 to RMB99,526 million for the six months ended June 30, 2004. The increase was mainly attributable to the further climbing of oil prices and the increase in the sales volume of oil and gas. During the first half of 2004, our average realized crude oil price was US$29.76 per barrel, representing an increase of 5.98% from US$28.08 per barrel for the corresponding period in the first half of 2003.

Intersegment sales increased 19.94% from RMB65,714 million for the six months ended June 30, 2003 to RMB78,818 million for the six months ended June 30, 2004. The increase was mainly due to the rise of oil prices and growth in sales volume of natural gas.

Operating Expenses Operating expenses increased 13.61% from RMB41,215 million for the six months ended June 30, 2003 to RMB46,825 million for the six months ended June 30, 2004. The increase was principally due to the augmentation in crude oil import from Russia, the increase in depreciation and depletion of fixed assets, increases in staff costs and fixed asset impairment provisions.

Profit from Operations Profit from operations increased 4.84% from RMB50,270 million for the six months ended June 30, 2003 to RMB52,701 million for the six months ended June 30, 2004.

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 rose 29.13% from RMB106,213 million for the six months ended June 30, 2003 to RMB137,149 million for the six months ended June 30, 2004. The increase was caused by an increase in sales volume and prices of key refined products.

Revenue from sales of gasoline grew 26.62% from RMB29,713 million for the six months ended June 30, 2003 to RMB37,621 million for the six months ended June 30, 2004. The increase was mainly due to soaring prices and sales volume. The average realized selling price of gasoline surged 11.96% from RMB3,003 per ton for the six months ended June 30, 2003 to RMB3,362 per ton for the six months ended June 30, 2004. The sales volume of gasoline increased 13.09% from 9.90 million tons for the six months ended June 30, 2003 to 11.19 million tons for the six months ended June 30, 2004.

Revenue from sales of diesel grew 28.03% from RMB48,808 million for the six months ended June 30, 2003 to RMB62,491 million for the six months ended June 30, 2004. The increase was mainly due to increased sales volume. The average realized selling price of diesel increased 7.55% from RMB2,771 per ton for the six months ended June 30, 2003 to RMB2,980 per ton for the six months ended June 30, 2004. The sales volume of diesel increased 19.05% from 17.62 million tons for the six months ended June 30, 2003 to 20.97 million tons for the six months ended June 30, 2004.

Revenue from sales of kerosene grew 27.99% from RMB2,056 million for the six months ended June 30, 2003 to RMB2,632 million for the six months ended June 30, 2004. The increase was mainly due to increased sales volume.

Intersegment sales revenue increased 17.86% from RMB8,064 million for the six months ended June 30, 2003 to RMB9,504 million for the six months ended June 30, 2004. The increase was mainly due to an increase in selling prices and sales volume.

Operating Expenses Operating expenses increased 24.26% from RMB103,146 million for the six months ended June 30, 2003 to RMB128,171 million for the six months ended June 30, 2004. The increase was mainly attributable to the increase of the purchase cost of crude oil and other feedstock from external suppliers.

Profit from Operations Profit from operations increased 192.73% from RMB3,067 million for the six months ended June 30, 2003 to RMB8,978 million for the six months ended June 30, 2004.

Chemicals and Marketing

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

Turnover Turnover rose 34.37% from RMB18,928 million for the six months ended June 30, 2003 to RMB25,434 million for the six months ended June 30, 2004. The growth in turnover of this segment was principally due to an increase in the sales volume and selling prices of chemical products.

Operating Expenses Operating expenses increased 28.45% from RMB18,280 million for the six months ended June 30, 2003 to RMB23,481 million for the six months ended

June 30, 2004. The increase was mainly due to increased expenses in the purchase of raw materials.

Profit from Operations Profit from operations increased 201.39% from RMB648 million for the six months ended June 30, 2003 to RMB1,953 million for the six months ended June 30, 2004.

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 sales of natural gas.

Turnover Turnover increased 14.66% from RMB7,777 million for the six months ended June 30, 2003 to RMB8,917 million for the six months ended June 30, 2004. The increase was primarily due to an increase in the sales volume of natural gas.

Operating Expenses Operating expenses increased 19.02% from RMB6,456 million for the six months ended June 30, 2003 to RMB7,684 million for the six months ended June 30, 2004. This was mainly due to increased expenses in the purchase of gas and an increase in depreciation charges caused by the commencement of operation of the eastern section of the West-East Gas Pipeline.

Profit from Operations Profit from operations decreased 6.66% from RMB1,321 million for the six months ended June 30, 2003 to RMB1,233 million for the six months ended June 30, 2004.

Liquidity and Capital Resources

For the six months ended June 30, 2004, the Group’s primary sources of funds were cash generated from operating activities, short-term and long-term borrowings. The Group's funds were used for operating activities, capital expenditures, repaying short-term and long-term borrowings and distribution of dividends to shareholders.

For the six months ended June 30, 2004, short-term debts represented approximately 6.18% of the Group’s capital employed as compared with approximately 5.97% for the six months ended June 30, 2003. Our ability to obtain adequate financing may be affected by our financial condition and operating results and the conditions of the domestic and foreign capital markets. We must seek approvals from the relevant PRC government authorities before raising funds in the domestic and foreign capital markets. In general, we must obtain PRC government approvals for any project involving significant capital investments in our Refining and Marketing segment, Chemicals and Marketing segment and the Natural Gas and Pipeline segment.

We plan to fund our capital and related investments principally from the cash generated from operating activities and short-term and long-term borrowings. For the six months ended June 30, 2004, net cash generated from operating activities was RMB66,668 million. As at June 30, 2004, we had cash and cash equivalents of RMB17,808 million. Cash and cash equivalents were mainly denominated in Renminbi (Renminbi accounting for approximately 79.56% and United States Dollar accounting for approximately 20.44%).

The table below sets forth our cash flows for the six months ended June 30, 2004 and the six months ended June 30, 2003 and our cash equivalents at the end of each period.

	Six months ended June, 30	
	2004	2003
	(RMB million)	(RMB million)
Net cash generated from operating activities	66,668	66,828
Net cash used for investment activities	(42,472)	(36,976)
Net cash used for financing activities	(17,619)	(20,495)
Cash and cash equivalents at the end of each period	17,808	19,334

Cash Generated from Operating Activities

Our net cash generated from operating activities during the first half of this year was basically the same as that during the corresponding period of last year. Our net cash generated from operating activities for the six months ended June 30, 2003 and for the six months ended June 30, 2004 were RMB66,828 million and RMB66,668 million respectively.

As at December 31, 2003, our working capital deficit was RMB27,855 million. As at June 30, 2004, our working capital was RMB635 million. The increase in working capital was primarily due to an increase in receivables under resale agreements, inventories, prepaid expenses and cash and cash equivalents.

Cash Used for Financing Activities

The table below sets out our net borrowings as at June 30, 2004 and December 31, 2003:

	June 30, 2004 (RMB million)	December 31,2003 (RMB million)
Short-term borrowings (including current portion of long-term borrowings)	28,608	28,890
Long-term borrowings	40,049	41,959
Total borrowings	68,657	70,849
Less:		
Cash and cash equivalents	17,808	11,231
Time deposits with maturities over three months	800	2,640
Receivables under resale agreements	37,464	24,224
Net borrowings	12,585	32,754

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

	Principal as at June 30, 2004 (RMB million)
To be repaid within one year	17,199
To be repaid within one to two years	9,804
To be repaid within two to five years	24,356
To be repaid after five years	5,889
	57,248

Of the total borrowings of the Group as at June 30, 2004, approximately 29.16% were fixed-rate loans and approximately 70.84% were floating-rate loans. Of the borrowings as at June 30, 2004, approximately 85.48% were denominated in Renminbi, approximately 12.73% were denominated in US Dollars, approximately 0.57% were denominated in British Sterling, approximately 0.72% were denominated in Japanese Yen, and approximately 0.50% were denominated in Euro.

As at December 31, 2003 and June 30, 2004, short-term borrowings owed to related parties were both RMB610 million. As at December 31, 2003 and June 30, 2004, long-term borrowings owed to related parties amounted to RMB24,578 million and RMB22,576 million respectively.

As at June 30, 2004, short-term borrowings and long-term borrowings owed to China Petroleum Finance Company Limited amounted to RMB610 million and RMB22,576 million respectively.

Our net cash used for financing activities decreased 14.03% during the six months ended June 30, 2004 compared with the six months ended June 30, 2003. This decrease was primarily due to lower net repayment compared with the corresponding period of last year.

As at June 30, 2004, loans of the Group consisted of RMB104 million secured loans (lease financing and bank loans) (RMB170 million as at December 31, 2003), of which RMB73 million (RMB114 million as at December 31, 2003) were secured by plant and equipment of the Group valued at RMB152 million (RMB152 million as at December 31, 2003). As ownership of leased assets will be transferred to the lessor in case of default, lease obligations are in fact secured obligations. As at June 30, 2004, finance lease obligations of the Group amounted to RMB31 million (RMB56 million as at December 31, 2003), and the book value of properties, plant and equipment held under finance lease was RMB144 million (RMB240 million as at December 31, 2003).

As at June 30, 2004, the debt to capitalization ratio was 15.04% (16.57% as at December 31, 2003).

Capital Expenditures

The table below sets out our capital expenditures by business segment for each of the six months ended June 30, 2004 and the six months ended June 30, 2003. During the first half of 2004, capital expenditures increased 8.68% to RMB28,853 million from RMB26,548 million of the corresponding period in 2003. The increase was due primarily to the continued increase in expenditures relating to oil and gas exploration and development, and acquisition of service stations.

	First half of 2004		First half of 2003		Estimate for 2004	
	(RMB million)	%	(RMB million)	%	(RMB million)	%
Exploration and Production	19,146*	66.36	17,336*	65.30	57,040*	62.66
Refining and Marketing	4,688	16.25	3,558	13.40	11,600	12.74
Chemicals and Marketing	1,062	3.68	1,123	4.23	6,190	6.80
Natural Gas and Pipeline	3,905	13.53	4,492	16.92	15,600	17.14
Others	52	0.18	39	0.15	600	0.66
Total	28,853	100.00	26,548	100.00	91,030	100.00

Note*: If geological and geophysical exploration costs were included, the capital expenditures and investments for the Exploration and Production segment for the first half of 2003 and the first half of 2004, and the estimate of the same for the entire 2004 would be RMB19,132 million, RMB21,646 million and RMB61,300 million respectively.

Exploration and Production

The majority of the Group's capital expenditures is related to the Exploration and Production segment. For the six months ended June 30, 2004, capital expenditures in relation to exploration and production amounted to RMB19,146 million, including RMB3,665 million for exploration activities and RMB14,481 million for development activities. For the six months ended June 30, 2003, capital expenditures in relation to this segment totalled RMB17,336 million, including RMB2,594 million for exploration activities and RMB13,909 million for development activities. The increase in capital expenditures was mainly due to the increased expenditures relating to oil and gas exploration and development.

It is estimated that for the twelve months ended December 31, 2004, capital expenditures of the Group in the Exploration and Production segment will amount to RMB57,040 million. Approximately RMB16,590 million will be used for oil and gas exploration, and approximately RMB40,450 million will be used for oil and gas development. Exploration and development will be mainly carried out in the Erdos, Junggar, Tarim, Songliao and Bohai Bay basins.

Refining and Marketing

For the six months ended June 30, 2004, capital expenditures of the Group in the Refining and Marketing segment amounted to RMB4,688 million, of which RMB3,386 million was spent on the expansion of the retail marketing network of our refined products and storage infrastructure facilities, and RMB1,302 million was spent on upgrading our refining facilities. For the six months ended June 30, 2003 , capital expenditures for this segment totalled RMB3,558 million. The increase in capital expenditures was mainly due to increased expenditures for acquisition of service stations.

It is estimated that capital expenditures of the Group for the Refining and Marketing segment for the twelve months ending December 31, 2004 will amount to RMB11,600 million, including approximately RMB5,100 million to be spent on construction and expansion of refining facilities; and approximately RMB6,500 million to be spent on investments in our refined product retail marketing network and addition of service stations and storage facilities.

Chemicals and Marketing

For the six months ended June 30, 2004, capital expenditures in the Chemicals and Marketing segment decreased 5.43% from RMB1,123 million for the six months ended June 30, 2003 to RMB1,062 million for the six months ended June 30, 2004. This was mainly due to a decrease of chemical engineering expenditures.

It is estimated that for the twelve months ended December 31, 2004, capital expenditures of the Group in the Chemicals and Marketing segment will amount to RMB6,190 million.

The capital expenditures will mainly be used for upgrading ethylene facilities in Daqing, Jilin and Lanzhou, expansion of the production capacity of the chemical fertiliser plants in Daqing, Ningxia and Urumqi and the PTA project at Liaoyang Petrochemical Company.

Natural Gas and Pipeline

For the six months ended June 30, 2004, capital expenditures in the Natural Gas and Pipeline segment amounted to RMB3,905 million. We spent RMB3,858 million of these expenditures on construction of long distance pipelines and RMB850 million of such amount on the West-East Gas Pipeline project. For the six months ended June 30, 2003, capital expenditures in the segment totalled RMB4,492 million. The decrease in capital expenditures was mainly due to a dramatic decrease in expenditures relating to the West-East Gas Pipeline project.

It is estimated that for the twelve months ended December 31, 2004, capital expenditures of the Group in the Natural Gas and Pipeline segment will amount to RMB15,600 million, of which approximately RMB13,400 million will be invested in the West-East Gas Pipeline project, the Zhongxian-Wuhan pipeline, and the second Shaanxi-Beijing pipeline and approximately RMB2,200 million will be invested in natural gas storage infrastructure facilities and natural gas, crude oil and refined product transmission pipelines.

Others

The Group's non segment-specific capital expenditures for the six months ended June 30, 2003 and for the six months ended June 30, 2004 were RMB39 million and RMB52 million respectively. These capital expenditures were mainly used for non segment-specific equipment purchases and research and development activities.

It is estimated that the Group's non segment-specific capital expenditures for the twelve months ended December 31, 2004 will amount to RMB600 million. These capital expenditures will be used for the construction of water and power supply systems, roads and telecommunications system for the benefit of various segments.

Material Investment

For the six months ended June 30, 2004, the Group did not hold any material investment.

Material Acquisition or Disposal

The Group had no material acquisition or disposal of subsidiaries and associated companies for the six months ended June 30, 2004.

Foreign Exchange Rate Risk

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. As the prices of the Group's crude oil and refined products are set generally with reference to United States Dollar-denominated prices in the international market, a devaluation of Renminbi against United States Dollar may not have a negative impact on the Group's turnover 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 turnover, 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 wide range of petroleum-related activities. The global oil and gas market is affected by international political, economic and military developments and global demand for and supply of oil and gas. As the prices of Chinese crude oil and refined products are determined by reference to international benchmark prices, fluctuations of prices of crude oil and refined products in the international market will directly or indirectly affect prices of Chinese crude oil and refined products. A decrease in the prices of crude oil and refined products could adversely affect the Group's financial position. Historically, the Group has not used derivative instruments to hedge against potential price fluctuations of crude oil and refined products. Accordingly, the Group is exposed to general price fluctuations of oil and gas commodities in 2004 and will remain to be so exposed thereafter.

Industry Risk

Like other oil and natural gas companies in China, the Company's operating activities are subject to regulation and control by the PRC government in many aspects. Regulation and control, such as by way of grant of exploration and production licences, the imposition of industry-specific taxes and levies and the implementation of environmental and safety standards, is expected to have an impact on the Company's business operations. As a result, the Company may be subject to relatively 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 June 30, 2003 and June 30, 2004, the Group had 419,415 and 417,163 employees respectively. The table below sets out the number of employees of business segments as at June 30, 2004:

	Number of Employees	% of total
Exploration and Production	234,768	56.28
Refining and Marketing	111,513	26.73
Chemicals and Marketing	57,701	13.83
Natural Gas and Pipeline	10,367	2.49
Others*	2,814	0.67
Total	417,163	100.00

Note*: Including management staff of PetroChina Exploration & Development Research Institute, PetroChina Planning & Engineering Institute, Oil Refining and Petrochemical Technological Research Centres, Company headquarters and business segment head offices.

Employee Compensation

For the six months ended June 30, 2004, the total employee compensation payable by the Group was RMB5,564 million, being the total salaries of employees during the reporting period. Compensation of employees is determined according to industry practice and the actual conditions of the Group, and is based on the principles of attracting and retaining high calibre personnel, and motivating all staff for the realization 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 account for approximately 70% to 75% of the 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.

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

Details of the directors' and supervisors' emoluments as at June 30, 2004 and June 30, 2003 are as follows:

	As at June 30, 2004 (RMB'000)	As at June 30, 2003 (RMB'000)
Fees for directors and supervisors	58	33
Salaries, allowances and other benefits	647	611
Contribution to retirement benefit scheme	17	18
	722	662

The number of directors and supervisors whose emoluments fall within the following band (including directors and supervisors whose term expired during the current period):

	As at June 30, 2004 Number	As at June 30, 2003 Number
Nil-RMB1,000,000	24	19

Upon exercise of their share options, senior management staff will not receive any shares in the Company. Instead, they will receive, by way of stock appreciation rights, 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 originally committed 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 focus on exploring the possibility of establishing a learning-oriented enterprise in its training programme. The Company will focus on the training of core employees, actively promote the training of all of its employees and strive to build up an operating and management team, a technology renovation team and a 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 are members of the basic medical insurance scheme organized by the Beijing Municipality, making contributions at 9% of the total salaries of the employees. Other regional companies of the Group have also participated in their respective local basic medical insurance schemes.

Basic medical insurance is organized by local authorities. The dates of implementation, rates of contribution and reimbursement methods vary with localities. The rate of contribution is generally set at 6% to 10% of the total basic salaries of the employees of various companies.

In accordance with relevant regulations of the PRC government, the Company has given permission to regional companies that have participated in local basic insurance schemes to establish a supplemental medical insurance scheme from 2002. Contributions to the schemes are set at not more than 4% of the total salaries and are expensed.

Contingent Liabilities

Information on the Group's contingent liabilities as of June 30, 2004 is as follows:

Bank and other guarantees

As at June 30, 2004, 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 expected that no material liabilities will arise.

	June 30, 2004 (RMB million)	December 31, 2003 (RMB million)
Guarantees in respect of borrowings of associated companies	211	448

Environmental Liabilities

CNPC and the Group have operated in China for many years and certain environmental problems have developed. China has adopted extensive environmental laws and regulations that affect the operation of the oil and gas industry. The impact of environmental liabilities under proposed or future environmental legislation cannot reasonably be estimated at present, and could be material. Under existing legislation, however, the management believes that there are no probable 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 outcome of such contingencies, lawsuits or other proceedings cannot be determined at present, the management believes that any liabilities which may arise 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 formation of the Company, CNPC has undertaken to the Company as follows:

- CNPC will use its best endeavours to obtain formal land use right certificates to replace the entitlement certificates in relation to the 28,649 parcels of land which were leased or transferred to the Company from CNPC, within one year from August, September and October 1999 when the relevant entitlement certificates were issued;

- CNPC will complete, within one year from November 5, 1999, the necessary governmental procedures for the requisition of the collectively-owned land on which 116 service stations owned by the Company are located; and

- CNPC will obtain individual building ownership certificates in the name of the Company for all of the 57,482 buildings transferred to the Company by CNPC, before November 5, 2000.

As at June 30, 2004, CNPC 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 did not complete the necessary governmental procedures for the above-mentioned service stations located on collectively-owned land. The Directors of the Company confirm that the use of and the conduct of relevant activities at the above-mentioned parcels of land, service stations and buildings are not affected by the fact that the relevant land use right certificates or individual building ownership certificates have not been obtained or the fact that the relevant governmental procedures have not been completed. In 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 damages 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 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 and operation facilities

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

Others

In December 2003, a gas blow-out incident occurred at one of the gas wells of the Group. The blow-out caused the leakage of a large quantity of sulfurated hydrogen, causing injuries and deaths to many residents living in the surrounding area. As a result of an investigation conducted by the PRC government, CNPC, which provided drilling services for the well, was held liable for this blow-out. The incident has not had, and the Company does not believe it will have, a material adverse effect on the results of operations and financial position of the Group.