

## **BUSINESS OPERATING REVIEW AND PROSPECTS**

### **Market Review**

#### *Crude Oil Market Review*

During the first half of 2004, international crude oil prices hit an all-time high due to geopolitical and economic developments and regional demand and supply imbalance. The average oil price rose to US\$66.66 and US\$33.14 per barrel respectively, representing an increase of US\$5.36, US\$4.89 and US\$3.08 per barrel respectively from the first half of 2003. Domestic crude oil prices also soared. WTI, Brent and Minas crude oil in the first half of the year averaged US\$36.81, US\$33.05 and US\$33.05 respectively under the impact of international oil prices. The average realized price was higher than that of the first half of 2003.

Chinese import of crude oil continued to grow during the first half of 2004. Chinese net crude oil import surged 46.12% to 57.95 million tons compared with the same period of last year. Chinese crude oil output and crude oil processed reached 86.38 million tons and 127 million tons respectively.

#### *Refined Products Market Review*

The domestic refined products market performed well during the first half of 2004. Nominal consumption increased 24.6% to 75.75 million tons compared with the same period of last year. Except for January and February in which consumption was low, demand for refined products, driven by rapid GDP growth, was strong in the other four months. The supply of refined products was relatively tight. By the end of June, the refined products inventory held by our company and Sinopec dropped to 8.14 million tons, a reduction of 0.38 million tons compared with the corresponding period of last year.

The PRC government has made appropriate adjustments to the prices of domestic refined products during the first half of 2004. However, under the impact of international oil prices, the average benchmark prices of gasoline and diesel were still higher than the level during the corresponding period of last year.

#### *Chemical Products Market Review*

During the first half of 2004, domestic investment and production activities were still growing rapidly. The Chinese GDP growth rate for the first quarter and the second quarter was recorded at 9.7% and 9.5% respectively. A strong market demand for petroleum and chemical products was created. Owing to sustained high crude oil prices in the international market and strong demand for downstream products, output of key petroleum and chemical products grew rapidly during the first half of 2004. Prices continued to surge, market sales were active and imports and exports grew steadily. Key economic targets hit historical high. Prices of all chemical products increased markedly from those of the corresponding period of last year.

There was a tight supply of resources in the first half of the year. Inventory as a whole dropped to a low level. The PRC economy grew steadily in line with the global economic recovery. The increase in demand for chemical products outpaced the growth of the domestic gross product. There was a strong demand for plastic and textile products and demand for aromatics soared in particular. As there was limited domestic production capacity, prices and output of chemical products increased.

It is estimated that in the second half of the year the global economy will continue to grow. In particular, economic development in the United States will accelerate and the European economy will also speed up its recovery. There will be increased demand for basic chemical materials which will lead to an increase in prices of chemical products. Global demand for chemical products will rise steadily.

In the second half of the year, prices of domestic chemical products will remain high, although prices may drop mildly compared with the first half of the year. Overall, it is expected that prices on average will be higher than those of the second half of last year.

In summary, persistent high crude prices will inevitably lead to US opposition and result in increased output by OPEC. This will push crude prices down gradually. The macro-economic control measures implemented by the PRC government will curb inappropriate investments in real estates and small-scale enterprises, which will in turn affect demand. Owing to sustained high prices, downstream enterprises are forced to operate at high costs for a long period of time which will affect the rate of operation of these enterprises. Over a certain period of time, this will result in excess supply over demand.

## **Business Review**

For the six months ended June 30, 2004, total oil and gas output of the Company was 456.9 million barrels of oil equivalent, including 388.5 million barrels of crude oil and 410.3 billion cubic feet of marketable natural gas, representing an average daily crude oil output of 2.12 million barrels and an average daily marketable natural gas output of 2,254 million cubic feet. A total of 366 million barrels of crude oil and 381 billion cubic feet of natural gas were sold. The Company sold approximately 81% of its crude oil to its refineries. During the first half of 2004, lifting cost of the Company (including overseas operations) was US\$4.45 per barrel. For the same period of 2003, lifting cost was US\$4.35 per barrel.

For the six months ended June 30, 2004, the Company's refineries processed 347 million barrels of crude oil, representing an average daily processed output of 1.91 million barrels. The Exploration and Production segment provided approximately 86% of the crude oil processed by the Company's refineries. The Company produced approximately 30.22 million tons of gasoline, diesel and kerosene and sold approximately 33.18 million tons of these products. The Company is actively expanding its sales network, and its retail network in particular in order to benefit from the synergy created by the integration of

refining and marketing. As at June 30, 2004, there were 16,677 service stations either owned, controlled or franchised by the Company or owned by CNPC but to which the Company provided supervisory support. The cash processing cost of the Company's refineries is constantly decreasing, from RMB132 per ton during the first half of 2003 to RMB129 per ton for the same period of 2004.

During the six months ended June 30, 2004, the Company produced 0.923 million tons of ethylene, 1.287 million tons of synthetic resin, 0.6293 million tons of synthetic fibre raw materials and polymer, 0.133 million tons of synthetic rubber, and 1.902 million tons of urea.

The Natural Gas and Pipeline segment is the Company's core business segment for development. For the six months ended June 30, 2004, the Company sold 321.4 billion cubic feet of marketable natural gas through its Natural Gas and Pipeline segment. As at December 31, 2003, the Company owned and operated 15,144 kilometres of regional natural gas pipeline network, of which 14,017 kilometres of the pipeline network were operated by the Natural Gas and Pipeline segment. The Company owned and operated 9,141 kilometres of crude oil pipeline and owned 2,276 kilometres of refined product pipeline.

### **The Second Half of 2004 and Beyond**

During the first half of 2004, the Company availed itself of the opportunity created by high oil prices and strong market demand for oil and chemical products, improved production organization and strengthened management of operation and in so doing, achieved rapid growth of operating results. The following exemplifies the excellent operating results: oil exploration realized important achievements and showed good development prospects; crude oil output increased steadily, natural gas output surged; marked increase in crude oil processed and refined products output, and key technological and economic indicators hit an all-time high; marketing efforts were enhanced, and sales and profitability grew at the same time; smooth progress of construction of key pipelines was made.

At present, international oil prices remain high. The effect of macro-economic control measures is becoming apparent. The Company is developing under favourable internal and external circumstances. During the second half of 2004, the Company will step up its exploration and development activities so as to locate more reserves and bring them into stream; further optimise the petrochemical business operations and conduct necessary structural adjustments to ensure the realization of increased output, sales and profits; make further efforts to the construction and commencement of operation of key pipelines in order to promote the fast development of natural gas business; accelerate merger and acquisition for the purposes of achieving rapid development; emphasise safe production to create a favourable environment for development.

In terms of the Exploration and Production segment, the Company will continue to give top priority to the exploration of resources. The Company will develop its oil and gas operations simultaneously, promote the integration of exploration and development, and achieve a benign cycle of replacement of resources, stable increase of crude oil output and speedy growth of natural gas output. In the development of oil and gas fields, there should be meticulous design of production efforts and co-ordination, active implementation of measures to increase output, consolidate the basis for stable output in aging oilfields, and speed up commencement of production in new oilfields. The Company will implement natural gas projects as a matter of priority in order to create new production capacity as soon as possible.

In terms of the refining and chemicals sectors, the Company will make full use of the current flourishing market demand to improve allocation of resources, promote technological advancement, improve processing procedures and the quality of processing, make prompt adjustments to the product mix and increase output of value-added products and readily marketable products. The Company will also strengthen management of the production process, plan for repair and maintenance arrangements in a scientific manner, ensure full-load operation of key facilities in a safe and stable manner and realization of the target of improved production and profitability, and speed up the pace of construction of key refining projects.

In terms of marketing, the Company will carry out market development actively, orderly and efficiently, and speed up the establishment of the marketing network. The Company will adhere to the principle of quality first, and focus on the development in central cities, main arteries and key locations, taking the rate of return on investment into consideration. The Company will strengthen management of existing stations and terminals as well as sales centres in order to enhance daily sales of individual stations and profit generating capability of sales centres. The Company will also broaden its institutional and consumer client base in order to increase the ratio of sales to end-users. Finally, the Company will speed up the establishment of the information infrastructure for marketing so as to build up a loyal customer base.

In terms of the Natural Gas and Pipeline segment, the Company will endeavour to improve the balance and connection between upstream resources, pipeline operation and downstream users carefully. The Company will co-ordinate the production, transmission and sale of natural gas, and ensure safe and stable supply of gas. The Company will strive to commence natural gas transmission from Lunnan in the western section of the West-East Gas Pipeline project on October 1, and to commence commercial supply of natural gas to Shanghai from Tarim by the end of this year. The Zhongxian-Wuhan main trunk line and the Xiangfan-Huangshi branch line will be ready for commercial gas transmission by the end of this year. The Company will speed up construction of the Shaanxi-Beijing Pipeline. The Daliangshan Tunnel and the

Zhangjiawan Tunnel have been completed. The Company will strive to complete construction of the trunk lines before October 30 this year.

The Company will continue to further develop its overseas operations, secure overseas resources and enhance the value of the Company.

In future, the Company will keep up its efforts in accelerating the development of key operations, take advantage of its edge in resources, and consolidate its leading position in the upstream sector in order to drive forward and co-ordinate the development of its business segments.

The management of the Company will strive to continue to enhance the value of the Company and maximise benefits and value for its shareholders. The Company intends to invest substantial efforts in technological and management innovations and promote the continuous, effective and speedy development of the Company.