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

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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, 2004, profit before taxation of the Group was RMB147,141 million, representing an increase of 49.7% compared with the corresponding period in the previous year. Net profit was RMB102,927 million, representing an increase of 47.9% compared with the corresponding period in the previous year. For the first time net profit of the Group exceeded RMB100,000 million. Profit in all four business segments recorded historical highs. The increase in profit was due primarily to the Group's ability to take full advantage of the opportunities presented by persistently high oil prices and strong market demand to enhance exploration and development and to increase oil and gas production, thereby achieving a steady increase in domestic crude oil production. Production and sales of refined oil and chemicals increased and the quantity of processed crude oil reached a record high. Production of natural gas continued to increase; and there is also a new breakthrough in the infrastructure of oil and gas pipelines. Management of the Company was also strengthened and technological and management innovations are introduced on an ongoing basis.

For the year ended December 31, 2004, the Company's basic and diluted earnings per share were RMB0.59.

Twelve Months Ended December 31, 2004 Compared With Twelve Months Ended December 31, 2003

Consolidated Operating Results

◆ Turnover

Turnover increased 27.9% from RMB303,779 million for the twelve months ended December 31, 2003 to RMB388,633 million for the twelve months ended December 31, 2004. This was due primarily to the increase in the price of crude oil and the increase in the prices and sales volume of natural gas, refined products and chemicals.

◆ Operating Expenses

Operating expenses increased 18.3% from RMB204,593 million for the twelve months ended December 31, 2003 to RMB242,047 million for the twelve months ended December 31, 2004. This was mainly attributable to an increase in the purchase cost of crude oil and refined products from external suppliers and increased depreciation and depletion caused by an increase in the amount of property, plant and equipment.

◆ Purchases, Services and Other Expenses

Purchases, services and other expenses increased 28.1% from RMB90,850 million for the twelve months ended December 31, 2003 to RMB116,353 million for the twelve months ended December 31, 2004. This was due primarily to (1) the increase in the purchase cost of crude oil from external suppliers resulted from the increase of crude oil price and the increase in the purchase volume of crude oil by the Company's refineries; and (2) the increase in the prices of refined oil and chemical products, which increased the purchase cost of refined oil and chemical products from external suppliers.

◆ Employee Compensation Costs

Employee compensation costs rose 14.2% from RMB19,542 million for the twelve months ended December 31, 2003 to RMB22,309 million for the twelve months ended December 31, 2004. This was due primarily to the increase in employees' salaries and welfare expenses as a result of strong operating results achieved by the Company, and the increase in labour costs as a result of further development of the Company's retail network.

◆ Depreciation, Depletion and Amortization

Depreciation, depletion and amortization increased 14.5% from RMB40,531 million for the twelve months ended December 31, 2003 to RMB46,411 million for the twelve months ended December 31, 2004. This was mainly attributable to an increase in impairment of assets and an increase in depreciation, 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 10.2% from RMB23,930 million for the twelve months ended December 31, 2003 to RMB26,377 million for the twelve months ended December 31, 2004. This was due primarily to an increase in transportation, repair and other related costs caused by an increase in the sales volume of refined oil and petrochemical products.

◆ Shutdown of Manufacturing Assets

The costs for shutting down manufacturing assets decreased by 90.7% from RMB2,355 million for the twelve months ended December 31, 2003 to RMB220 million for the twelve months ended December 31, 2004, including RMB192 million for shutting down inefficient facilities in the Refining and Marketing segment, and RMB28 million for shutting down inefficient facilities in the Chemicals and Marketing segment.

◆ Taxes other than Income Tax

Taxes other than income tax increased 17.7% from RMB15,879 million for the twelve months ended December 31, 2003 to RMB18,685 million for the twelve months ended December 31, 2004. The increase was due primarily to: (i) 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; and (ii) an increase in compensation fees for mineral resources due to an increase in crude oil revenue.

◆ Profit from Operations

As a result of the factors discussed above, profit from operations increased 47.8% from RMB99,186 million for the twelve months ended December 31, 2003 to RMB146,586 million for the twelve months ended December 31, 2004.

◆ Net Exchange Gain (Loss)

Net exchange loss decreased 59.4% from RMB180 million for the twelve months ended December 31, 2003 to RMB73 million for the twelve months ended December 31, 2004. The decrease in net exchange loss was mainly due to a decrease in the average proportion of foreign exchange borrowings and a dramatic slowdown in the appreciation of foreign currencies against Renminbi.

◆ Net Interest Expenses

Net interest expenses decreased 28.3% from RMB1,669 million for the twelve months ended December 31, 2003 to RMB1,196 million for the twelve months ended December 31, 2004. The decrease in net interest expenses was due primarily to sufficient cash flow generated from operating activities and a decrease in the average proportion of interest-bearing debts.

◆ Profit Before Taxation

Profit before taxation rose 49.7% from RMB98,322 million for the twelve months ended December 31, 2003 to RMB147,141 million for the twelve months ended December 31, 2004.

◆ Taxation

Taxation increased 51.6% from RMB28,072 million for the twelve months ended December 31, 2003 to RMB42,563 million for the twelve months ended December 31, 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 47.9% from RMB69,614 million for the twelve months ended December 31, 2003 to RMB102,927 million for the twelve months ended December 31, 2004.

Information on Business Segments

The Group operates a wide range of petroleum and related activities through four primary business segments: Exploration and Production segment, Refining and Marketing segment, Chemical and Marketing segment, and Natural Gas and Pipeline segment.

Exploration and Production

The business of the Exploration and Production segment includes the exploration, development, production and marketing of petroleum and natural gases.

◆ Turnover

Turnover increased 25.4% from RMB177,271 million for the twelve months ended December 31, 2003 to RMB222,305 million for the twelve months ended December 31, 2004. The increase was mainly attributable to an increase in the price of crude oil and an increase in the sales volume of natural gas. The average realized crude oil price of the Company in 2004 was US$33.88 per barrel, representing an increase of US$6.68 per barrel and 24.6% from US$27.20 per barrel compared with the corresponding period in the previous year.

Intersegment sales increased 36.8% from RMB128,963 million for the twelve months ended December 31, 2003 to RMB176,458 million for the twelve months ended December 31, 2004. The increase was mainly due to an increase in the price of crude oil and an increase in the sales volume of natural gas.

◆ Operating Expenses

Operating expenses increased 13.9% from RMB84,901 million for the twelve months ended December 31, 2003 to RMB96,734 million for the twelve months ended December 31, 2004. The increase was mainly due to the increase in crude oil import from Russia, the increase in exploration expenses, depreciation and depletion of fixed assets and the increase in staff costs.

◆ Profit from Operations

Profit from operations increased 35.9% from RMB92,370 million for the twelve months ended December 31, 2003 to RMB125,571 million for the twelve months ended December 31, 2004.

Refining and Marketing

The business of the Refining and Marketing segment includes refining, storage and marketing of crude oil and petroleum products.

◆ Turnover

Turnover rose 32.2% from RMB223,584 million for the twelve months ended December 31, 2003 to RMB295,598 million for the twelve months ended December 31, 2004. The increase was caused by an increase in the prices and sales volume of key refined products, of which:

Sales revenue from gasoline increased 28.0% from RMB60,073 million for the twelve months ended December 31, 2003 to RMB76,919 million for the twelve months ended December 31, 2004. The average realized selling price of gasoline surged 17.2% from RMB3,023 per ton for the twelve months ended December 31, 2003 to RMB3,542 per ton for the twelve months ended December 31, 2004, resulting in an increase in revenue by RMB11,267 million. The sales volume of gasoline increased 9.3% from 19.87 million tons for the twelve months ended December 31, 2003 to 21.71 million tons for the twelve months ended December 31, 2004, resulting in an increase in revenue by RMB5,579 million.

Sales revenue from diesel increased 36.2% from RMB100,336 million for the twelve months ended December 31, 2003 to RMB136,649 million for the twelve months ended December 31, 2004. The average realized selling price of diesel increased 15.7% from RMB2,735 per ton for the twelve months ended December 31, 2003 to RMB3,165 per ton for the twelve months ended December 31, 2004, resulting in an increase in revenue by RMB18,567 million. The sales volume of diesel increased 17.7% from 36.68 million tons for the twelve months ended December 31, 2003 to 43.18 million tons for the twelve months ended December 31, 2004, resulting in an increase in revenue by RMB17,746 million.

Sales revenue from kerosene increased 42.6% from RMB4,125 million for the twelve months ended December 31, 2003 to RMB5,881 million for the twelve months ended December 31, 2004.

Intersegment sales revenue increased 29.6% from RMB16,867 million for the twelve months ended December 31, 2003 to RMB21,862 million for the twelve months ended December 31, 2004. The increase was mainly due to an increase in selling prices and intersegment sales volume.

◆ Operating Expenses

Operating expenses increased 29.8% from RMB218,549 million for the twelve months ended December 31, 2003 to RMB283,617 million for the twelve months ended December 31, 2004. The increase was mainly attributable to the increase in the purchase cost of crude oil and refined oil from external suppliers, and an increase in staff cost, selling and administrative expenses.

◆ Profit from Operations

Profit from operations increased 137.9% from RMB5,035 million for the twelve months ended December 31, 2003 to RMB11,981 million for the twelve months ended December 31, 2004.

Chemicals and Marketing

The business of the Chemicals and Marketing segment consists of the production and sales of basic petrochemical products, derivative petrochemical products and other chemical products.

◆ Turnover

Turnover rose 45.8% from RMB39,211 million for the twelve months ended December 31, 2003 to RMB57,179 million for the twelve months ended December 31, 2004. The growth in turnover of this segment was mainly due to an increase in the sales volume and selling prices of the chemical products.

◆ Operating Expenses

Operating expenses increased 29.7% from RMB38,170 million for the twelve months ended December 31, 2003 to RMB49,524 million for the twelve months ended December 31, 2004. The increase was mainly due to an increase in the expenses for the purchase of raw materials and an increase in selling and administrative expenses.

◆ Profit from Operations

Profit from operations increased 635.4% from RMB1,041 million for the twelve months ended December 31, 2003 to RMB7,655 million for the twelve months ended December 31, 2004.

Natural Gas and Pipeline

The business of the Natural Gas and Pipeline segment consists of the delivery of natural gas, crude oil and refined oil, and the sales of natural gas.

◆ Turnover

Turnover increased 21.2% from RMB15,067 million for the twelve months ended December 31, 2003 to RMB18,255 million for the twelve months ended December 31, 2004. The increase was mainly due to an increase in the sales volume, and volume of natural gas from pipeline transmission.

◆ Operating Expenses

Operating expenses increased 19.6% from RMB13,145 million for the twelve months ended December 31, 2003 to RMB15,720 million for the twelve months ended December 31, 2004. The increase was mainly due to an increase in expenses for the purchase of gas and an increase in depreciation charges caused by the commencement of operation of the West-East Gas Pipeline.

◆ Profit from Operations

Profit from operations increased 31.9% from RMB1,922 million for the twelve months ended December 31, 2003 to RMB2,535 million for the twelve months ended December 31, 2004.

Liquidity and Capital Resources

For the twelve months ended December 31, 2004, the Group's primary sources of funds were cash generated from operating activities, short-term and long-term borrowings, cash and cash equivalents. The

Group's funds were used for operating activities, capital expenditures, repayment of short-term and long-term borrowings and distribution of dividends to shareholders.

As at December 31, 2004, short-term borrowings made up approximately 5.5% of the Group's capital employed as compared with approximately 6.7% as at December 31, 2003. The Group's ability to obtain adequate financing may be affected by the financial condition and operating results and the conditions of the domestic and foreign capital markets. The Group must seek approvals from the relevant PRC government authorities before raising funds in the domestic and foreign capital markets. In general, the Group must obtain PRC government approvals for any project involving significant capital investments in the Refining and Marketing segment, the Chemicals and Marketing segment and the Natural Gas and Pipeline segment.

The Group plans to fund its capital and related investments principally from the cash generated from operating activities, short-term and long-term borrowings, cash and cash equivalents. For the twelve months ended December 31, 2004, net cash generated from operating activities was RMB137,299 million. As at December 31, 2004, the Group had RMB11,304 million in cash and cash equivalents. Cash and cash equivalents were primarily Renminbi (with Renminbi accounting for approximately 71.1% and United States Dollar accounting for approximately 28.9%).

The table below sets forth the cash flow of the Group for each of the twelve months ended December 31, 2004 and 2003 and the cash and cash equivalents at the end of each period.

	As at year ended December 31	
	2004	2003
	RMB million	RMB million
Net cash flow generated from operating activities	137,299	137,236
Net cash flow employed for investment activities	(98,533)	(96,213)
Net cash flow employed for financing activities	(38,693)	(39,769)
Cash and cash equivalents at the end of each period	11,304	11,231

Cash Flow Generated from Operating Activities

The net cash flow of the Group generated from operating activities for the twelve months ended December 31, 2004 was RMB137,299 million which is basically the same as the RMB137,236 million generated for the twelve months ended December 2003. This was due to an increase in sales revenue as well as an increase in the amount of expenditure and the amount of income tax payable. In addition, the level of inventories also increased resulting from an increase in the scale of its sales.

As at December 31, 2004, the Group had a working capital deficit of RMB3,348 million compared with a working capital deficit of RMB27,855 million as at December 31, 2003. The decrease in working capital deficit was mainly due to an increase in inventories resulting from an increase in the scale of its sales and an increase in receivables under resale agreements.

Cash Used for Financing Activities

The net borrowings of the Group as at December 31, 2004 and December 31, 2003 are as follows:

	As at year ended December 31	
	2004	2003
	RMB million	RMB million
Short-term borrowings (including liquid portion of long-term borrowings)	27,276	28,890
Long-term borrowings	38,458	41,959
Total borrowings	65,734	70,849
Less:		
Cash and cash equivalents	11,304	11,231
Time deposits with maturities over three months	1,400	2,640
Receivables under resale agreements	33,217	24,224
Net borrowings	19,813	32,754

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

	Principal as at December 31, 2004	Principal as at December 31, 2003
	RMB million	RMB million
To be repaid within one year	16,008	19,711
To be repaid within one to two years	8,130	18,183
To be repaid within two to five years	22,961	17,108
To be repaid after five years	7,367	6,668
	54,466	61,670

Of the total borrowings of the Group as at December 31, 2004, approximately 27.1% were fixed-rate loans and approximately 72.9% were floating-rate loans. Of the borrowings as at December 31, 2004, approximately 85.1% were denominated in Renminbi, approximately 13.2% were denominated in US Dollars, approximately 0.5% were denominated in British Pound Sterling, approximately 0.7% were denominated in Japanese Yen, and approximately 0.5% were denominated in Euro.

As at December 31, 2004 and December 31, 2003, the amount of short-term borrowings owed to related parties was RMB600 million and RMB610 million, respectively. As at December 31, 2004 and December 31, 2003, the amount of long-term borrowings owed to related parties was RMB22,568 million and RMB24,578 million, respectively.

As at December 31, 2004, the amount of short-term and long-term borrowings owed to China Petroleum Finance Company Limited was RMB600 million and RMB22,568 million, respectively.

The net cash used for financing activities for the twelve months ended December 31, 2004 decreased 2.7% compared with the twelve months ended December 31, 2003. The decrease was mainly due to lower net repayment compared with the corresponding period of last year.

As at December 31, 2004, loans of the Group consisted of RMB50 million (RMB170 million as at December 31, 2003) secured loans (finance lease and bank loans), of which RMB29 million worth of bank loans (RMB114 million as at December 31, 2003) were secured by plant and equipment of the Group valued at RMB218 million (RMB152 million as at December 31, 2003). 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, 2004, the debts incurred by the Group by way of finance lease amounted to RMB21 million (RMB56 million as at December 31, 2003). The net book value of property, plant and equipment under finance lease was RMB175 million (RMB240 million as at December 31, 2003).

As at December 31, 2004, the debt to capitalization ratio (debt to capitalization ratio = interest-bearing debts / (interest-bearing debts + shareholder's equity)) was 13.4% (16.6% as at December 31, 2003).

Capital Expenditures

The table below sets out our capital expenditures by the business segments for each of the twelve months ended December 31, 2004 and the twelve months ended December 31, 2003. As at December 31, 2004, capital expenditures increased 15.0% to RMB95,349 million from RMB82,929 million as at December 31, 2003. The increase was mainly due to an increase in expenditures relating to oil and gas exploration and development and continuation in putting in greater efforts in the construction of the sales network.

	Year ended December 31,					
	2004		2003		2005 (estimated value)	
	RMB million	%	RMB million	%	RMB million	%
Exploration and Production	59,488*	62.4	52,713*	63.6	61,160*	62.7
Refining and Marketing	17,467	18.3	12,650	15.2	14,590	15.0
Chemicals and Marketing	4,319	4.5	3,898	4.7	8,350	8.6
Natural Gas and Pipeline	13,901	14.6	13,530	16.3	12,400	12.7
Other	174	0.2	138	0.2	1,000	1.0
Total	95,349	100	82,929	100	97,500	100

Note: *If geological and geophysical exploration costs were included, the capital expenditures and investments for the Exploration and Production segment for 2003 and 2004, and the estimate of the same for the entire 2005 would be RMB58,599 million, RMB66,493 million and RMB66,660 million, respectively.

◆ Exploration and Production

The majority of the Group's capital expenditures is related to the Exploration and Production segment. For the twelve months ended December 31, 2004, capital expenditures in relation to exploration and production amounted to RMB59,488 million, including RMB11,308 million for exploration activities and RMB43,217 million for development activities. For the twelve months ended December 31, 2003, capital expenditures in relation to this segment totalled RMB52,713 million, including RMB9,250 million for exploration activities and RMB39,587 million for development activities. The increase in capital expenditures was mainly due to an increase in expenditures relating to oil and gas exploration and development as well as strategic adjustments in the east and the speeding up of production in the west, and an increase in expenditures relating to exploration and development of gas fields in the Tarim, Sichuan and Erdos basins.

The Group anticipates that capital expenditures for the Exploration and Production segment for the twelve months ending December 31, 2005 will amount to RMB61,160 million. Approximately RMB10,960 million will be used for oil and gas exploration, and approximately RMB50,200 million will be used for oil and gas development. Exploration and development will be mainly carried out in the Erdos, Junggar, Tarim, Songliao, Sichuan and Bohai Bay basins.

◆ Refining and Marketing

Capital expenditures for the Group's Refining and Marketing segment for the twelve months ended December 31, 2004 amounted to RMB17,467 million, of which RMB11,729 million was spent on the expansion of the retail sales network of refined products and storage infrastructure facilities, and RMB5,738 million was spent on renovation of refining facilities. The total capital expenditures of this segment for the twelve months ended December 31, 2003 were RMB12,650 million. The increase in capital expenditures was mainly due to the continual increase in the 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, 2005 will amount to RMB14,590 million, which include:

- approximately RMB7,250 million for construction and expansion of refining facilities;
- approximately RMB7,340 million for investments in the development of the refined product sales network.

◆ Chemicals and Marketing

Capital expenditures for the Chemicals and Marketing segment for the twelve months ended December 31, 2004 and 2003 amounted to RMB4,319 million and RMB3,898 million respectively. The increase was mainly due to an increase in investments in the ethylene projects in Daqing, Jilin and Lanzhou.

The Group anticipates that capital expenditures for the chemicals and marketing segment for the twelve months ended December 31, 2005 will amount to RMB8,350 million, which is expected to be used primarily for upgrading ethylene facilities in Daqing, Jilin, Lanzhou and Dushanzi 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, 2004 amounted to RMB13,901 million. The Group spent RMB13,462 million of these expenditures on the construction of long distance pipelines, of which RMB3,425 million was spent on the West-East Gas Pipeline project. For the twelve months ended December 31, 2003, capital expenditures in the segment totalled RMB13,530 million. The increase in capital expenditures was mainly due to an increase in investments in the Zhongxian-Wuhan and the second Shaanxi-Beijing pipelines projects.

The Group anticipates that capital expenditures for the Natural Gas and Pipeline segment for the twelve months ending December 31, 2005 will amount to RMB12,400 million. Approximately RMB7,000 million is expected to be invested in the West-East Gas Pipeline project, the Zhongxian-Wuhan pipeline and the second Shaanxi-Beijing pipeline projects and approximately RMB5,400 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, 2004 and for the twelve months ended December 31, 2003 were RMB174 million and RMB138 million respectively. These capital expenditures were mainly used for 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, 2005 will amount to RMB1 billion, which is expected to be used primarily for technology research, information system, construction of water and electricity supply systems, roads and telecommunications system for the mutual benefit of various segments.

Material Investment

The Group did not hold any material investment for the year ended December 31, 2004.

Material Acquisition or Disposal

The Group had not made any material acquisition or disposal of subsidiaries and associated companies for the year ended December 31, 2004.

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 the 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 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 condition 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. The Group has not used derivative instruments to hedge against potential price fluctuations of crude oil and refined products. Therefore, during 2004 and 2003, the Group was exposed to general price fluctuations of widely traded oil and gas commodities.

Industry Risk

Like other 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 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 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, 2003 and December 31, 2004, the Group had 417,229 and 424,175 employees respectively. The table below sets out the number of employees by business segment as at December 31, 2004:

	Number of Employees	Percentage of total (%)
Exploration and Production	236,591	55.8
Refining and Marketing	116,813	27.5
Chemicals and Marketing	57,765	13.6
Natural Gas and Pipeline	10,191	2.4
Other(*)	2,815	0.7
Total	424,175	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

The total employee compensation payable by the Group for the twelve months ended December 31, 2004 was RMB14,926 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 in attaining best results.

The Company's senior management remuneration system links senior management financial interests (including those of executive directors and supervisors) with the Company's operating results and the market performance of its shares. Members of the senior management 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 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.

	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, 2004 and December 31, 2003 are as follows:

	2004	2003
	RMB '000	RMB '000
Fees for directors and supervisors	120	83
Salaries, allowances and other benefits	2,012	1,377
Contribution to retirement benefit scheme	43	34
	2,175	1,494

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

	2004	2003
	Number	Number
Nil-RMB1,000,000	24	19

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 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.

◆ Training Programs

In order to develop the Company into an internationally competitive oil company, the Company has targeted high-calibre and skilful staff in its training program for 2004 with a focus on the training of core personnel and implementation of a "strong corporate and high talent" strategy, actively promoted the training of all of its employees and strived to build a proficient operating and management team, a technology innovation team and a skilful operators' team so as to achieve an overall improvement in the quality of its staff and to ensure the supply of talents required for the continuous, steady and relatively speedy 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 basic salaries of the employees. Other regional branches of the Company have also participated in their respective local basic medical insurance schemes.

As 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 will be booked as cost.

Contingent Liabilities

Information on the Group's contingent liabilities as of December 31, 2004 is as follows:

◆ Bank and other guarantees

As at December 31, 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 anticipated that no material liabilities will arise.

	2004	2003
	RMB million	RMB million
Guarantees of borrowings of associates	203	448

◆ Environmental liabilities

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, which 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 resulting legal 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 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 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, 2004, CNPC had obtained formal land use right certificates in relation to 26,549 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 the 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 and therefore 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 and operation 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 they may have a material adverse effect on the Group's results of operations.

◆ Other

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.