# Management Discussion and Analysis



## BUSINESS REVIEW AND PROSPECTS

As at 31 December 2005, our total revenue amounted to RMB69,455.7 million (US$8,470.4 million), representing a year-on-year increase of 25.8%. Net profit amounted to RMB25,323.1 million (US$3,088.3 million), representing a year-on-year increase of 56.9%. The profit growth was attributable to the following reasons: due to the increased oil price and high market demand, we seized favorable opportunities from such optimism and strengthened our exploration and development to actively expand our production capacity of oil and gas. We continued to implement effective cost control measures and maintained our leadership position in production cost per barrel among our peers.

As at 31 December 2005, the Company's basic and diluted earnings per share were RMB0.62 and RMB0.61 respectively.

Looking ahead, it is expected that the global economy will maintain positive development and the demand for energy will continue to rise. It apparently appears that oil price will likely stay at high level. We will increase our capital expenditure and strengthen exploration activities. More work will be done on the acquisitions of seismic data as well as exploration drilling. The development projects will also be conducted in a continual and highly efficient manner. There will be sixteen new projects in progress in 2006, of which ten of them are expected to commence operation during the year. The large number of oil and gas fields put into development are also expected to contribute positively to achieve the Company's production target.

In 2006, we will consistently maintain a healthy financial position and continue to expand our overseas development and pursuit of opportunities for acquisition. At the same time, our exploration work will be extended to deepwater area.

The management remains confident in the development potential of the Company.

## CONSOLIDATED NET PROFIT

Our consolidated net income after tax was RMB25,323.1 million (US$3,088.3 million) in 2005, an increase of RMB9,184.0 million (US$1,120.0 million), or 56.9% from RMB16,139.1 million in 2004.

## REVENUE

Income from our oil and gas sales for 2005 was RMB53,417.7 million (US$6,514.5 million), respesenting an increase of RMB16,531.7 million (US$2,016.1 million), or 44.8% from RMB 36,886.0 million in 2004. The increase was attributable to the high oil price, whilst growth in production also attributed to higher profits in the Company. The average realised price for our crude oil was US$47.31 per barrel in 2005, respesenting an increase of US$11.9, or 33.6% from US$35.41 per barrel in 2004. Sale of crude oil amounted to 129.8 million barrels, respesenting an increase of 11.6% over 2004. The average realised price for our natural gas was US$2.82 per thousand cubic feet in 2005, respesenting an increase of US$0.07, or 2.6% from US$2.75 per thousand cubic feet in 2004. At the same time, sales volume of our natural gas increased by 6.8% from 21.9 million BOE in 2004 to 23.4 million BOE in 2005.

In 2005, our net marketing profit, which was derived from marketing revenue less purchase cost of crude oil and oil products, was RMB197.2 million (US$24.1 million), respesenting a decrease of RMB30.7 million (US$3.7 million), or 13.5%, from RMB227.9 million in 2004. Marketing revenue from the Company's wholly-owned subsidiary, CNOOC China Limited, was RMB9,430.8 million (US$1,150.1 million), respesenting an increase of RMB1,688.2 million (US$205.9 million) from RMB 7,742.6 million in 2004. The net marketing profit was RMB85.0 million (US$10.4 million), however, 45.7% decreased from the same period last year due to the significant reduction in sales margin which was mainly influenced by market price in local market. Marketing revenue from the Company's wholly-owned subsidiary, China Offshore Oil (Singapore) International Pte Ltd., was RMB6,470.5 million (US$789.1 million). Netting off purchase cost of crude oil and oil production, the net marketing profit was RMB112.2 million (US$13.7 million), or 57.4% increased from the same period last year.

Our other income, reported on a net basis, was derived from our other income less corresponding costs. In 2005, our other net income was RMB59.7 million (US$7.3 million), respesenting a decrease of RMB39.1 million (US$4.8 million) from RMB98.8 million in 2004. The decrease mainly came from the fluctuation of income from service fee relating to PSC projects.

## EXPENSES

### Operating expenses

Our operating expenses in 2005 were RMB5,934.6 million (US$723.7 million), respesenting an increase of RMB864.3 million (US$105.4 million), or 17.0% from RMB 5,070.3 million in 2004. The increase was mainly attributable to the commencement of production of seven new oil and gas fields in China in the year. Operating expenses in 2005 were RMB38.8 (US$4.73) per BOE, an increase of 5.7% from RMB36.7 (US$4.43) per BOE in 2004. Operating expenses offshore China in 2005 were RMB32.5 (US$3.96) per BOE, respesenting an increase of 8.7% from 2004. The increase was mainly attributable to the higher service fees, supply vessels, equipment lease, maintenance materials, chemicals and fuel, resulting from the higher international crude oil price. Operating expenses offshore Indonesia in 2005 were RMB100.2 (US$12.22) per BOE, respesenting an increase of 13.0% from 2004. The increase in operating expenses per barrel for our Indonesian oil fields was due to lower net production volume based on their production sharing models. Based on working interest production, operating expenses in offshore Indonesia in 2005 were RMB48.7 (US$5.94) per BOE.

### Production taxes

Our production taxes for 2005 were RMB2,596.5 million (US$316.7 million), respesenting an increase of RMB870.8 million (US$106.2 million), or 50.5% from RMB1,725.7 million in 2004. The increase was mainly due to the increased income from oil and gas sales.

### Exploration costs

Our exploration costs for 2005 were RMB1,293.7 million (US$157.8 million), a slight decrease of RMB22.5 million (US$2.7 million), or 1.7% from RMB1,316.2 million in 2004, as a result of increase in capitalisation of investment in exploration.

### Depreciation, depletion and amortisation

Our depreciation, depletion and amortisation were RMB5,964.7 million (US$727.4 million) for 2005, respesenting an increase of RMB509.6 million (US$62.1 million), or 9.3% from RMB 5,455.1 million in 2004. Our average depreciation, depletion and amortisation per barrel were RMB39.0 (US$4.75) per BOE which were more or less the same as those in 2004.

### Dismantlement

Our dismantling costs for 2005 were RMB252.9 million (US$30.8 million), an increase of RMB51.3 million (US$6.3 million) from RMB201.6 million in 2004. The increase was primarily due to the increased dismantling costs resulting from the commencement of production at new oil and gas fields and a revision of the dismantlement liabilities for certain existing oil and gas fields. Our average dismantling costs were RMB1.7 (US$0.20) per BOE, a corresponding increase from RMB1.5 (US$0.18) per BOE in 2004.

### Impairment losses related to property, plant and equipment

Our impairment losses for 2005 were RMB90.2 million (US$11.0 million). The impairment was due to the downward revision of the reserve of BZ34-2/4 and HZ19-3 oil and gas fields. The average impairment costs were RMB0.6 (US$0.07) per BOE.

### Selling and administrative expenses

Our selling and administrative expenses for 2005 were RMB1,370.4 million (US$167.1 million), respesenting an increase of RMB266.1 million (US$32.5 million), or 24.1% from RMB1,104.3 million in 2004. Of which, the selling and administrative expenses of companies in China were RMB6.3 (US$0.77) per BOE, respesenting an increase of 14.5% from the previous year. Compared with last year, the increase was mainly attributable to the increase in management fees related to more PSC projects in production, labor costs and general research expenditures occurred in 2005.

### Finance costs, net of interest income

Our net finance costs for 2005 were RMB741.2 million (US$90.4 million), an increase of 215.5% from the net interest expenses of RMB235.0 million in 2004. On one hand, our interest income increased RMB152.4 million from RMB206.9 million in 2004 to RMB359.3 million in 2005. On the other hand, the finance costs increased significantly mainly due to the interest expenses on our US$1 billion bonds issued in December 2004, the losses on fair value changes of the embedded derivative component of the convertible bonds and the effect of increased amount of provision of dismantlement arising from the passage of time. The increases due to the factors mentioned above were RMB164.4 million (US$20.1 million), RMB373.1 million (US$45.5) and RMB79.2 million (US$9.7 million) respectively.

### Exchange gains/losses, net

Our net exchange gains incurred in 2005 were RMB287.0 million (US$35.0 million), an increase of RMB257.7 million (US$31.4 million) from net exchange gains of RMB29.3 million in 2004. Compared with 2004, the increased exchange gains mainly came from the Chinese government's efforts on the improvement of rate-forming mechanism and the following appreciation of RMB in the second half of the year.

### Investment income

Our investment income for 2005 was RMB247.9 million (US$30.2 million), a significant increase of RMB175.5 million (US$21.4 million), or 242.4% from RMB72.4 million in 2004. For the purpose of improving performance of current assets portfolio, we increased the investment in financial instruments such as money market funds. Benefiting from the structural changes in the investment portfolio and the influence from the market, we obtained a favorable return in this year.

### Share of profits of associates

In 2005, there were gains from our investments in Shanghai Petroleum and Natural Gas Company Limited and CNOOC Finance Corporation Limited. Of them, share of profit from Shanghai Petroleum and Natural Gas Company Limited was RMB261.8 million (US$31.9 million), respesenting a decrease of 12.1% from 2004, which was mainly due to the change in tax rate from favorable rate of 16.5% to normal rate of 33.0% and resulting from the increased income tax payment of 2005. Share of profit from CNOOC Finance Corporation Limited was RMB45.3 million (US$5.5 million) during the period, relatively comparable to that from 2004.

### Non-operating income/expenses, net

Our net non-operating income for 2005 was RMB28.6 million (US$3.5 million), and our net non-operating income for 2004 was RMB 519.2 million. The non-operating income in 2004 represented the tax refund from re-investment in China.

### Income tax

Our income tax for the year 2005 was RMB10,977.8 million (US$1,338.8 million), respesenting an increase of RMB4,047.0 million (US$493.5 million), or 58.4% from RMB6,930.8 million in 2004. The primary reason for the increase was the increase in profit before tax. The effective tax rate for 2005 was 30.2%, slightly higher than the effective rate of 30.0% in 2004.

### Cash generated from operating activities

Net cash generated from operating activities in 2005 amounted to RMB32,153.8 million (US$3,921.3 million), respesenting an increase of RMB9,825.9 million (US$1,198.3 million), or 44.0% from RMB22,327.9 million in 2004.

The increase in cash was mainly due to an increase in profit before tax of RMB13,231.0 million (US$1,613.6 million), an increase in depreciation, depletion and amortization expenses of RMB509.7 million (US$62.2 million), an increase in finance costs of RMB658.7 million (US$80.3 million), an increase in provision for inventory of RMB35.8 million (US$4.4 million), an increase in dismantlement costs of RMB51.2 million (US$6.2 million), a decrease in share of profits of associates of RMB37.4 million (US$4.6 million), an increase in amortisation of discount of long term guaranteed notes of RMB26.3 million (US$3.2 million), and an increase in impairment losses related to property, plant and equipment of RMB90.2 million (US$11.0 million).

Increase of cash flow was also partially offset by an increase of income tax paid of RMB2,447.2 million (US$298.4 million), an increase in our finance exchange gain and loss of RMB257.8 million (US$31.4 million), an increase in investment income received of RMB175.5 million (US$21.4 million), a decrease in the loss on disposal and write off of property, plant and equipment of RMB14.3 million (US$1.7 million), an increase in interest income of RMB152.4 million (US$18.6 million) and a decrease in compensation cost for share based payment of RMB17.5 million (US$2.1 million).

In another aspect, compared with 2004, the increase in operating cash flow was partially attributable to the increase in changes of working capital, mainly due to the increase in changes of current assets from operating activities excluding cash and bank balances of RMB2,103.9 million (US$256.6 million), and a simultaneous increase in changes of current liabilities from operating activities of RMB71.0 million (US$8.7 million).

### Capital expenditures and investments

Net cash outflow from investing activities in 2005 was RMB29,349.2 million (US$3,579.3 million), representing an increase of RMB4,742.0 million (US$578.3 million) from RMB24,607.2 million in 2004.

In line with our use of "successful efforts" method of accounting, total capital expenditures and investments primarily include successful exploration and development expenditures and purchases of oil and gas properties. Total capital expenditures were RMB17,469.5 million (US$2,130.5 million) in 2005, representing a decrease of RMB1,152.5 million (US$140.6 million), or 6.2%, from RMB18,622.0 million in 2004. Capital expenditures in 2005 mainly comprised of RMB875.8 million (US$106.7 million) for capitalised exploration activities, RMB15,729.7 million (US$1,918.4 million) for development investments, and RMB1,017.0 million (US$124.0 million) for acquisition of 16.69% equity interest of MEG, netting off a tax refund of RMB153.0 million (US$18.7 million) from NWS Project. Our development expenditures in 2005 related principally to the development of PanYu 30-1, Bozhong 25-1/25-1S, PL19-3 phase II, NanPu 35-2 oil and gas fields.

In addition, cash outflow was attributable to the increase in time deposits with maturities over three months of RMB3,597.0 million (US$438.7 million), and the net purchase of available-for-sale financial assets of RMB8,282.7 million (US$1,010.1 million).

### Financing activities

The net cash flow arising from financing activities in 2005 was an outflow of RMB7,786.4 million (US$ 949.6 million) while that in 2004 was an inflow of RMB1,970.5 million. Compared with 2004, there was no issuance of debt financing instruments or bank loan increase in 2005. The distribution of dividends of RMB7,772.2 million (US$947.9 million) and the repayment of bank loans of RMB18.7 million (US$2.3 million) by the Company generated a total cash outflow of RMB 7,790.9 million (US$950.1 million). Some cash inflow was generated by the proceeds from the exercise of share options of RMB4.5 million (US$0.5 million) in 2005.

Repayment arrangements of our total debts as at 31 December 2005 were as follows:

| | Debt maturities principal only Original currency | | | | |
|---|---|---|---|---|---|
| **Due by 31 December** | **US$** | **JPY** | **RMB** | **Total RMB equivalent** | **Total US$ equivalent** |
| | *(in millions, except percentages)* | | | | |
| 2006 | 100.0 | 271.5 | — | 825.7 | 102.3 |
| 2007-2009 | 1,000.0 | 271.4 | — | 8,088.9 | 1,002.3 |
| 2010-2011 | — | — | — | — | — |
| 2011 and beyond | 1,000.0 | — | — | 8,070.2 | 1,000.0 |
| Total | 2,100.0 | 542.9 | — | 16,984.8 | 2,104.6 |
| Percentage of total debt | 99.8% | 0.2% | — | 100.0% | 100.0% |

The gearing ratio of the Company was 19.1%. Gearing ratio is (Total Debt)/(Total Debt + Equity).

## Market risks

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

## Oil and gas price risk

As our oil and gas prices are mainly determined by reference to the oil and gas prices in international markets, changes in international oil and gas prices have a large impact on us. International oil and gas prices are volatile, and this volatility has a significant effect on our net sales and net profits.

## Currency risk

Substantially all of the Group's oil and gas sales are denominated in Renminbi and US dollars. In the past decade, the PRC government's policies of maintaining a stable exchange rate and China's ample foreign reserves have contributed to the stability of the Renminbi. Starting from 21 July 2005, China reformed the exchange rate regime by moving into a managed floating exchange rate regime based on market supply and demand with reference to a basket of currencies. Renminbi would no longer be pegged to US dollar. From that day to 31 December 2005, Renminbi has appreciated by approximately 2.5% against US dollars.

The appreciation of Renminbi against US dollars may have certain impact on the Group. On one hand, since the benchmark oil and gas prices are usually in US dollars, the Group's oil and gas sales may decrease due to the depreciation of US dollars against Renminbi. On the other hand, the depreciation of US dollars against Remminbi will also decrease the Group's costs for imported equipment and materials. In addition, the debt repayment by the Group will decrease since more than 99% of the Group's debts are also denominated in U.S. dollars.

As of the end of 2005, the balance of our yen-denominated loans was only RMB37.3 million. Since the Group has hedged our yen loans against foreign currency swaps, the Group does not expect any exchange risk relating to Japanese yen in the future.

## Interest rate risk

As of the end of 2005, the interest rates for all balance of our debts were fixed. The term of the weighted average balance was approximately 8 years. The average interest rate payable by the Group is favorable under the environment of interest rate hike.

## Significant investments and material acquisitions

i) On 11 March 2005, CNOOC reached agreement with Canadian MEG Energy Corporation, on the acquisition of 18.5% (16.69% on a diluted basis) of the issued shares of MEG Energy Corp., for a consideration of C$150 million. The Company thereby acquired an interest in the oil sand project in Canada, which has a huge development potential.

ii) On 23 June 2005, the Company made a merger proposal to Unocal Corporation to acquire all the shares of Unocal Corporation at US$67 per share, or a total consideration of approximately US$18.5 billion. However, in light of huge uncertainties and unbearable risks associated with the political environment in the US, the Company finally withdrew its offer on 2 August 2005.

iii) On 8 January 2006, the Company signed a definitive agreement with South Atlantic Petroleum Limited ("SAPETRO") to acquire a 45% working interest in an offshore oil mining license 130 "OML 130" in Nigeria for a cash consideration of US$2.268 billion. Conditional on, among other things, the approval of the Nigerian National Petroleum Corporation ("NNPC") and the PRC government, the transaction is expected to be completed in the first half of 2006.

iv) On 27 January 2006, the Company acquired a 35% working interest in the Nigeria OPL229 for a consideration of US$60 million.

## EMPLOYEES

We had 2,696 employees as at 31 December 2005.

We have adopted share option schemes for directors, senior management officers and other eligible grantees of the Company since 4 February 2001. The Board has granted options to eligible grantees pursuant to the terms of the relevant schemes in effect from time to time.

In 2005, we further improved the implementation and utilization of performance-based assessment system and continued implementing the “target management” and “Balance Score Card” effectively. We also upgraded our remuneration systems and various incentive systems and formulated “Proposal for employees’ remuneration and its adjustments”. At the same time, we accomplished the task of standardising our internal remuneration and awarded a number of prizes and awards. We effectively awarded employees who made contribution to our development while further standardised the existing remuneration and benefits system.

We put great emphasis on the cultivation and development of our staff and increased our efforts and strength on training. By continuously improving the training and management system of the Company, formulating the standard for training as well as establishing and amending on-line training, we provide our staff with all kinds of management and business training, which is beneficial to both our staff and the development of the enterprise.We strive to create a win-win situation for our staff and the enterprise.

Furthermore, we continue implementing and refining our competitive remuneration and benefits packages for overseas employees. We have also started establishing a pool of talented staff which will guarantee the provision of the necessary resources to cater for our strategic opportunities for continuous fast growth.

## CHARGES ON ASSETS

Except for the change on the interest of the Group in the NWS Project as discussed in note 4 to the financial statements, the Group had no charge on assets as at 31 December 2005.

## CONTINGENT LIABILITIES

The Group had no contingent liabilities as at 31 December 2005.